EXHIBIT NO. ___(DAD-4T)
DOCKET NO. UE-121697/UG-121705
DOCKET NO. UE-130137/UG-130138
WITNESS: DANIEL A. DOYLE

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET NOS. UE-121697 and UG-121705 (*consolidated*)
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET NOS. UE-130137 and UG-130138 (*consolidated*)

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF
DANIEL A. DOYLE
ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 5, 2014

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY
(NONCONFIDENTIAL) OF DANIEL A. DOYLE

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PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF DANIEL A. DOYLE

I. INTRODUCTION

Q. Are you the same Daniel A. Doyle who provided prefiled rebuttal testimony and supporting exhibits on behalf of Puget Sound Energy, Inc. ("PSE") in these proceedings?

A. Yes, I filed prefiled rebuttal testimony, Exhibit No. ___(DAD-1T), and two supporting exhibits, Exhibit No. ___(DAD-2) and Exhibit No. ___(DAD-3)

Q. What is the purpose of your testimony?

A. First, my testimony provides a background and overview of this remand proceeding, including PSE's view as to the issues that the Commission should address on remand. Second, my testimony provides a summary of the authorized rate of return that is currently in effect and that PSE requests the Commission approve in this proceeding. Third, my testimony addresses the under-earning that PSE continues to face, which is a risk the Commission should consider when setting return on equity ("ROE"). Fourth, I discuss the earnings sharing provision and the impact it has on PSE's ability to earn its authorized return on equity. Finally, I address factors the Commission should consider with respect to cost of capital and decoupling, if the Commission determines this is an appropriate subject matter for this limited remand proceeding.

II. BACKGROUND AND OVERVIEW OF THIS REMAND PROCEEDING

Q. What is the purpose of PSE's filing in this phase of the proceeding?

A. PSE's filing provides substantial evidence demonstrating that the ROE of 9.8 percent authorized by the Washington Utilities and Transportation Commission (the "Commission") in Order 08 in Dockets UE-111048 and UG-111049 remained within the range of reasonableness when the Commission issued Order 07[1] in these proceedings and remains within the range of reasonableness under current market conditions.

PSE's filing also demonstrates that the Commission should not adjust PSE's authorized capital structure or authorized rate of return to adjust for a hypothetical but unproven reduction of risk related to decoupling. The studies undertaken on this topic do not support the premise that decoupling reduces cost of capital. Moreover, the majority of commissions in other jurisdictions have not adjusted utilities' ROEs or capital structures when approving decoupling. Since 2011, only one commission order resulted in a utility's ROE being reduced as a result of decoupling.

There are conflicting views as to the scope of the evidence to be presented in this remand proceeding. It is PSE's view that the Commission should limit its review to the return on equity component of the cost of capital, as set forth in the Thurston County Superior Court order, and PSE requests that the Commission

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[1] *WUTC v. Puget Sound Energy, Inc.*, Order 07 Final Order Granting Petition, Dockets UE-121697, *et al*. (consolidated) (June 25, 2013).

limit its review to that issue. However, because other parties take the position that the Commission should also consider more broadly PSE's capital structure, PSE is presenting evidence to demonstrate its current capital structure was reasonable in 2013 and remains reasonable at the present time. PSE provides this evidence to avoid any later claims that PSE has not met its burden of proof because it presented evidence on return on equity only and not on cost of capital.

As discussed in more detail in my testimony and the testimony of other PSE witnesses, the evidence from the first half of 2013 supports a higher cost of capital than what PSE agreed to in the 2013 proceeding. The evidence supports (i) an ROE in excess of 9.8 percent and (ii) a capital structure including an equity ratio and a long-term debt ratio both in excess of 48 percent.

Despite this evidence justifying a higher cost of capital, PSE is committed to the terms it proposed to the Commission in its 2013 filings—a multi-year rate plan with decoupling based upon an authorized ROE of 9.8 percent and an authorized rate of return of 7.77 percent that includes an equity ratio of 48 percent.

Q. Please briefly explain the events leading up to this filing.

A. In the Commission's Order 07, the Commission approved an expedited rate filing, decoupling mechanisms and a multi-year rate plan that fairly balanced customers' interests and PSE's interests.

There were several driving forces for the Commission's Order 07. The evidence demonstrated that PSE has historically been unable to earn its authorized rate of return despite frequent rate case filings, due in large part to regulatory lag and lost revenues resulting from PSE's energy efficiency efforts. Additionally, the Commission had expressed a policy interest in utilities implementing full electric and natural gas decoupling mechanisms to remove barriers to conservation, including the throughput incentive.

Order 07 addressed all of the issues identified above. Order 07 approved electric and natural gas decoupling mechanisms, a one-time expedited rate filing, and a multi-year rate plan that allowed PSE a better opportunity to recover its fixed costs, reduce regulatory lag, and enhance the potential to earn its authorized rate of return. Order 07 also benefitted customers by limiting the amount of annual rate increases during the course of the multi-year rate plan and allowing customers a new opportunity to share in any earnings above PSE's authorized rate of return.

With the implementation of these carefully balanced mechanisms, the Commission did not adjust PSE's authorized ROE as part of the decoupling and expedited rate filing proceedings in 2013.

The Public Counsel Section of the Attorney General's Office ("Public Counsel") and the Industrial Customers of Northwest Utilities ("ICNU") filed petitions for judicial review challenging several aspects of Order 07 in Thurston County Superior Court. In its final order, the Thurston County Superior Court rejected two of the three arguments made by Public Counsel and ICNU but remanded one issue to the Commission. Specifically, the court (i) affirmed the Commission's decision not to hold a general rate case in these dockets, (ii) affirmed the Commission's use of an attrition adjustment (also referred to as K-factor or the rate plan), and (iii) reversed the Commission's findings of fact with respect to the return on equity component of PSE's cost of capital in the context of a multi-year rate plan. The court remanded the case to the Commission to determine whether substantial evidence supports the Commission's determination that the authorized ROE of 9.8 percent remains within a range of reasonableness.

PSE's filing in this remand proceeding provides substantial evidence demonstrating that the ROE of 9.8 percent authorized by the Commission in Order 08 in Dockets UE-111048 and UG-111049 remained within the range of reasonableness when the Commission issued its Order 07 in these proceedings and remains within the range of reasonableness under current market conditions.

Q. What evidence is PSE providing in this remand proceeding with respect to the return on equity?

A. PSE is proffering the Prefiled Direct Testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), and supporting exhibits thereto, which demonstrate that the authorized ROE of 9.8 percent was within a range of reasonableness, albeit at the low end of the range, in the first half of the calendar year 2013 when the Commission issued Order 07, and that an authorized ROE of 9.8 percent remains in a range of reasonableness based on current market conditions.

Q. Should the Commission address on remand the issue of whether PSE's cost of capital should be lowered due to the adoption of decoupling to reflect alleged reduced risk to PSE?

A No. The Commission should not address on remand the issue of whether PSE's cost of capital should be lowered due to the adoption of decoupling to reflect alleged reduced risk to PSE.

In the 2012-2013 phase of this proceeding, PSE and the NW Energy Coalition ("NWEC") demonstrated that there is no empirical evidence to support the premise that decoupling lowers risk such that PSE's cost of capital should be lowered with the adoption of a decoupling mechanism. The Commission considered this evidence and determined that any reduction in the cost of debt would occur only prospectively and should be evaluated in PSE's next general rate case:

> Experience going forward with decoupling in place for PSE as various of its debt instruments mature over the next several years will provide valuable information to the Commission.[2]

Similarly, the Commission determined that parties could bring forth evidence in PSE's next general rate case on the issue of whether equity markets respond to the implementation of decoupling in the case of publicly traded companies.[3]

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[2] Order 07 at ¶ 105.

[3] *Id*. at ¶ 106.

Q. Is PSE presenting evidence with respect to the effect of decoupling on cost of capital in this proceeding?

A. Yes. Although PSE believes that the Commission appropriately determined not to prospectively adjust cost of capital with the adoption of decoupling, there remains disagreement among the parties as to whether this issue falls within the scope of the remand. Therefore, PSE is proffering the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ___(MJV-1T), and supporting exhibits thereto, which demonstrate there is no empirical evidence supporting the theory that decoupling lowers the cost of capital.

Dr. Vilbert and his colleagues at The Brattle Group have studied this issue extensively over the past several years, and Dr. Vilbert testifies that decoupling is instituted as a policy response to support other regulatory goals, such as eliminating the throughput incentive. Effective energy efficiency programs and distributed generation generally result in decreasing sales, which, in conjunction with volumetric rates, frustrate utilities' ability to fully recover their fixed costs. The adoption of decoupling helps mitigate this impact and is an important factor in aligning utility and public policy objectives. This, in turn, is important as electric and gas utilities seek to provide safe and reliable service, while also being a change agent in society's move to ever greater efficiency, lower energy use, more renewable power, and remain financially sound in the process.

Q. Please summarize the findings and conclusions in Dr. Vilbert's testimony?

A. The Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ___(MJV-1T), demonstrates that:

(1) statistical studies have been performed on both the gas and electric industries and do not support the contention that decoupling reduces cost of capital;

(2) any measurable impact of decoupling on cost of capital, if any, cannot be distinguished or allocated in any factual manner between the cost of debt and the cost of equity that comprise the overall cost of capital;

(3) decoupling mechanisms, as well as other alternative forms of ratemaking, are common among electric and natural gas utilities, including the peer groups that Dr. Morin uses in his cost of capital studies; and

(4) since 2011, only one commission order resulted in a utility's ROE being reduced as a result of decoupling.

Regarding point (3) above, it would be inappropriate double-counting to include an additional decrement in cost of capital for decoupling, when decoupling and these other alternative rate making mechanisms are already factored into the results of the overall cost of capital study.

Q. Please introduce the other witnesses who are presenting testimony in this case.

A. In addition to Dr. Morin and Dr. Vilbert, PSE is proffering the Prefiled Direct Testimony of Mr. Brandon J. Lohse, Exhibit No. ___(BJL-1T). Mr. Lohse is PSE's Corporate Treasurer, and his testimony and supporting exhibits demonstrate that the equity component in PSE's capital structure was above 48 percent as of March 31, 2013, and remains above 48 percent at September 30,

2014. Mr. Lohse also presents testimony with respect to PSE's debt costs, which PSE adjusted in 2013 to reflect the lower cost of debt for PSE's refinanced Pollution Control Bonds. Finally, Mr. Lohse presents evidence in support of PSE's currently authorized rate of return of 7.77 percent, which includes the authorized ROE of 9.8 percent addressed in Dr. Morin's testimony.

III. OVERVIEW OF THE AUTHORIZED RATE OF RETURN THAT PSE IS REQUESTING IN THIS PROCEEDING

Q. What is PSE's overall authorized rate of return and return on equity?

A. PSE's authorized rate of return is 7.77 percent and its authorized return on equity is 9.80 percent.

Q. Is PSE requesting a change to its authorized rate of return or return on equity?

A. No. PSE is requesting that the Commission retain the current 7.77 percent rate of return and the 9.8 percent return on equity approved by the Commission, although PSE's actual capital structure and rate of return support a higher authorized cost of capital as discussed later in my testimony.

Q. What was the basis for the currently authorized rate of return and return on equity?

A. The currently authorized rate of return was set in PSE's 2011-2012 general rate case and was updated in May at the time of the hearing in this proceeding to reflect a change in the cost of long-term debt--specifically, Pollution Control Bonds that were being refinanced at the time of the hearing. Table 1 below shows the capital structure and overall rate of return that was approved in the 2011 general rate case and adjusted for refinancing of Pollution Control Bonds in the 2013 ERF/Decoupling proceeding, as set forth in Mr. Lohse's testimony.

Table 1. Capital Structure and Overall Rate of Return

Capital Component	Capital Structure	Cost Rate	Weighted Cost
Short-Term Debt	4.0%	2.68%	0.11%
Long-Term Debt	48.0%	6.16%	2.96%
Common Equity	48.0%	9.80%	4.70%
Overall Rate Of Return	100.0%	N/A	7.77%

Q. Have there been changes in PSE's actual capital structure and cost of capital since the 2011-2012 general rate case?

A. Yes, PSE's actual mixture of long-term and short-term debt is different than the level in the hypothetical capital structure set May 2012. As demonstrated in Mr. Lohse's testimony, PSE's actual capital structure consisted of 1.37 percent short-term debt as of March 31, 2013 and 1.02 percent short-term debt as of September 30, 2014. PSE's capital structure consisted of 50.19 percent long-term debt as of March 31, 2013 and 50.90 percent long-term debt as of September 30, 2014. Additionally, PSE has maintained its equity percentage at 48.0 percent for both of these time periods. In addition to the refinancing of the Pollution Control Bonds that was incorporated into Order 07 in this docket, PSE entered into two new five-year credit facilities totaling $1 billion in February 2013 that are included in short-term debt.

Q. Why is PSE using less short-term debt than the amount in the hypothetical capital structure approved in May 2012?

A. PSE's cash-flow situation has changed significantly since the Final Order was entered in the 2011-12 general rate case in May 2012. One of the drivers of this change is the Treasury Grants PSE has received over the past two years. PSE received $205 million in Treasury Grants for the Lower Snake River wind project, and PSE is passing back to customers the proceeds from these Treasury Grants over a ten-year period. In addition, PSE received Treasury Grants for the Snoqualmie Falls and Baker hydroelectric projects in April and May 2014. At Commission Staff's request, the Treasury Grants for these two projects are no longer included in a tracker but are treated as a reduction to PSE's production rate base. The proceeds from the Treasury Grants associated with these hydroelectric projects total $108 million and are being amortized over the remaining life of the facilities. The additional cash resulting from these Treasury Grants—as well as bonus depreciation and the sale of PSE's Jefferson County service territory—have reduced PSE's need to utilize short-term borrowings since 2013 and for the foreseeable future. Therefore, the level of short-term debt as a component of PSE's overall capital structure on an actual basis as of March 31, 2013 and September 30, 2014 is less than the level contemplated in the hypothetical capital structure set in the 2011 general rate case.

Q. Please explain further why the actual short-term debt components of the capital structure and the actual cost rates changed from what was included in the hypothetical capital structure adopted and approved in the 2011 general rate case.

A. Certainly. For starters, the short-term debt component of the capital structure and related cost rates tend to be dynamic and difficult to predict for several reasons. First, short-term debt is the place where PSE's total cash flow is managed on the margin. Large changes in cash inflows or outflows can swing the level of short-term debt dramatically. Examples of these include the Treasury Grants and the sales proceeds from the Jefferson County transaction, discussed earlier. This makes the level of short-term debt more difficult to predict.

Second, short-term interest rates tend to be more volatile than longer-term rates due to the impacts of changing inflation, among others. This presents added uncertainty in predicting the level of short-term interest rates and, ultimately, the overall cost rate for short-term debt.

Third, PSE like many other utilities finances short-term debt with both commercial paper and revolving lines of credit with banks and will generally use the least expensive vehicle at the time of borrowing. However, commercial paper markets are very sensitive to economic turbulence and can become illiquid for periods of time making them impossible to access or more expensive than other forms of short-term borrowing. Accordingly, it is not possible to predict with accuracy what vehicle will be used and at what levels. A comparison of the assumptions used in setting the hypothetical capital structure relative to short-term debt to those that underpin actual results as of March 31, 2013 and September 30, 2014 make this point abundantly clear. The commercial paper markets have remained very liquid and less expensive, and, as such, PSE has not accessed its revolving lines of credit with any frequency in recent times. Last, relative to the cost rate aspect of the discussion, the all-in cost of short-term debt includes line of credit commitment fees and short-term debt related amortization schedules. Because these amounts do not change with the level of borrowing, any reduction in actual borrowing versus assumed borrowing will, all else equal, result in an increase in the actual cost rate compared to the assumed cost rate. Conversely, any increase in actual borrowing versus assumed borrowing will, all else equal, result in a decrease in the cost rate compared to the assumed cost rate. A review of Mr. Lohse's calculations of the actual short-term debt cost rates as of March 31, 2013 and September 30, 2014 in comparison to the same calculations used in deriving the hypothetical capital structure in the 2011 general rate case are illustrative in this regard. All of these factors work together to make the task of accurately predicting the percentage of short-term debt in the capital structure and related cost rates challenging, if not impossible.

Q. What is the basis for PSE's proposal to maintain the 7.77 percent overall rate of return?

A. The authorized 7.77 percent rate of return that has been in effect since July 1, 2013 is reasonable and, in fact, conservative in light of PSE's actual capital structure, debt costs and equity costs.

Q. Is the authorized equity ratio of 48 percent sufficient for the remainder of the rate plan?

A. Although an authorized equity ratio of 48 percent is currently below the average equity ratio authorized by state regulatory agencies in 2013 and a higher authorized equity ratio would undoubtedly improve PSE's overall financial profile and ability to raise capital, PSE proposes no change to the authorized equity ratio of 48 percent embedded in the authorized rate of return of 7.77 percent for the following reasons:

(i) PSE has maintained an actual capital structure with an equity ratio at or above 48 percent during 2013 and 2014;

(ii) PSE intends to maintain an actual capital structure with an equity ratio at or above 48 percent at least for the remainder of the rate plan;

(iii) at an authorized ROE of 9.8 percent, and under normal and anticipated operating and economic conditions, PSE's ability to access the capital markets should not be impaired for the remainder of the rate plan; and

(iv) PSE agreed to a multi-year rate plan with limited rate increases and an earnings cap based on the understanding that PSE's authorized capital structure would include an equity ratio of 48 percent and an authorized ROE of 9.8 percent.

Q. If the Commission were to reduce PSE's authorized ROE in this proceeding, should the Commission also adjust PSE's authorized capital structure?

A. Yes. If the Commission were to reduce PSE's authorized ROE in this proceeding, the Commission should also adjust PSE's authorized capital structure, as necessary, to maintain an authorized rate of return of 7.77 percent, to which PSE agreed in the first half of 2013 as part of the rate plan. This authorized rate of return should maintain PSE's financial profile and ability to raise capital during the remainder of the rate plan. Stated alternatively, maintaining the 7.77 percent rate of return is consistent with PSE's rationale for agreeing to the stay out component of rate plan.

Q. Does PSE recommend the same authorized rate of return for PSE's electric and natural gas operations?

A. Yes. PSE recommends the same authorized rate of return for PSE's electric and natural gas operations. PSE is an integrated electric and natural gas utility and does not run separate electric and natural gas divisions. Capital acquired to finance PSE's activities is not earmarked for either electric or natural gas operations. Therefore, it is appropriate for the Commission to set rates for PSE based on a single overall rate of return for electric and natural gas operations, an approach that has been followed consistently by the Commission. Additionally, Dr. Morin has based his cost of capital studies on PSE's integrated operations without any distinction between electric and natural gas operations, and Dr. Morin has specifically based his studies upon peer groups of similar investment-grade dividend-paying combination gas and electric utilities.

Q. Is PSE's recommended authorized ROE of 9.8 percent reasonable?

A. Yes. As discussed in the Prefiled Direct Testimony of Dr. Roger A. Morin, Exhibit No. ___(RAM-1T), PSE's recommended authorized ROE of 9.8 percent is at the low end of the range of reasonable returns based on the capital market conditions prevailing in the first half of 2013 and remains well below the midpoint of the range based on capital market conditions prevailing in the second half of 2014.

Q. Why is PSE not requesting an increase in either its authorized ROE or rate of return?

A. Although Dr. Morin's testimony demonstrates that a higher authorized ROE is appropriate, PSE agreed to an authorized ROE of 9.8 percent return on equity as part of the multi-year rate plan and the adoption of decoupling mechanisms. Therefore, PSE will accept the authorized ROE of 9.8 percent, along with an overall rate of return of 7.77 percent, even though Dr. Morin's testimony and evidence indicates that a higher authorized ROE is justifiable for PSE. As indicated in Dr. Morin's testimony, the mid-point of the reasonable ranges of ROEs based on market conditions in the first half of 2013 was 10.30 percent, which is 50 basis points higher than PSE's currently authorized ROE of 9.80 percent. Had Dr. Morin presented this cost of capital study in the context of a general rate case, PSE would likely have advocated for such an authorized ROE at that time.

Also, PSE is willing to accept the capital structure and overall rate of return that was put in place and authorized by the Commission as of July 1, 2013, even though PSE's actual capital structure and cost of capital support an actual rate of return in the 7.89 to 7.95 percent range.

IV. PSE CONTINUES TO UNDER-EARN

Q. Has PSE been under recovering its costs in the recent past?

A. Yes. PSE's filed Commission Basis Reports demonstrate that PSE has annually earned less than its authorized rate of return, despite the allowed increases in general rates.

Table 2 below provides a comparison of PSE's actual earnings, as reflected on Commission Basis Reports, to the authorized rate of return and ROE in place during the respective calendar year for electric operations.

Table 2. Comparison of PSE's Actual Electric Earnings to Authorized Rate of Return and ROE

	Rate of Return		Return on Equity	
Year	**Normalized**	**Authorized**	**Normalized**	**Authorized**
2013	7.56%	7.785%	9.06%	9.80%
2012	7.14%	7.80%	8.11%	9.80%
2011	6.62%	8.10%	6.98%	10.10%
2010	6.07%	8.10%	5.57%	10.10%
2009	6.11%	8.25%	5.63%	10.15%
2008	6.39%	8.25%	5.94%	10.15%
2007	8.13%	8.40%	9.89%	10.40%

Table 3 below provides a comparison of PSE's actual earnings reflected on Commission Basis Reports to the authorized rate of return and ROE in place during the respective calendar year for gas operations.

Table 3. Comparison of PSE's Actual Gas Earnings to Authorized Rate of Return and ROE

	Rate of Return		Return on Equity	
Year	**Normalized**	**Authorized**	**Normalized**	**Authorized**
2013	7.34%	7.785%	8.62%	9.80%
2012	7.46%	7.80%	8.78%	9.80%
2011	6.78%	8.10%	7.30%	10.10%
2010	6.24%	8.10%	5.92%	10.10%
2009	6.10%	8.25%	5.61%	10.15%
2008	6.52%	8.25%	6.32%	10.15%
2007	7.34%	8.40%	8.07%	10.40%

V. EFFECTS OF THE EARNINGS SHARING PROVISION ON RETURN ON EQUITY

Q. Please provide an overview of the earnings sharing provision approved by the Commission as part of the rate plan.

A. In paragraph 165 of Order 07 the Commission required that to the extent PSE's earnings exceed its currently authorized rate of return of 7.77 percent, such excess earnings should be shared equally, that is 50/50, between customers and PSE. Stated alternatively, for every two dollars of excess earnings PSE will retain one dollar and refund one dollar to customers.

Q. Why did the Commission implement such a sharing mechanism?

A. Broadly speaking, the Commission wanted to retain the incentive for PSE to continue to identify efficiencies in its cost structure, the full effect of which should be captured in PSE's next general rate case. PSE and NWEC initially proposed an earnings sharing mechanism that included a 25 basis point dead band. Under that proposal, 50/50 sharing would have begun after PSE over-earned its 7.77 percent rate of return by 25 basis points, or 8.02 percent. However, the Commission viewed PSE's 9.8 return on equity to be at the high end of a range of reasonableness. As a result, the Commission required that any earnings that exceed PSE's authorized rate of return of 7.77 percent must be shared equally between PSE and customers.[4]

Q. Does this sharing mechanism have any impact on PSE's earnings profile?

A. Yes, the sharing mechanism creates an asymmetrical earnings profile around PSE's 7.77 percent rate of return. In very simple terms, PSE must earn two dollars to receive one dollar of upside earnings but is impacted dollar for dollar on the downside when it has yet to earn its allowed rate of return. This relationship alters the traditional balance that should exist in a utility's opportunity to earn its allowed rate of return.

Q. Please explain in more detail the asymmetry in earnings that results from the earnings sharing provision implemented as part of this proceeding.

A. Authorized rates of return and ROEs are set for utilities with the understanding that there should be the opportunity for utilities to earn those benchmarks on average over time. In other words, utilities may over-earn and under-earn their authorized rates of return and ROEs, but, all things being equal, the average actual rates of return and ROEs will approximate the authorized rates of return and ROEs over time. However, it is important to recognize that "all things are not

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[4] Order 07 at ¶¶ 164-65.

equal" in terms of how over-earning and under-earning balance out when an earnings sharing mechanism is implemented. PSE originally proposed the sharing of earnings after 25 basis points of over-earning (i.e., the dead band) because it mitigates some of the asymmetry on rates of return and ROE associated with the earnings sharing and it better maintained upside and downside parity around the opportunity to earn its authorized rate of return and ROE. This is demonstrated on Exhibit No. ___(DAD-5).

Q. Please elaborate.

A. Rates of return and ROEs are related, in that reductions to rates of return will have direct effects on ROEs. The difference between regulated income (the numerator in ROE) and regulated operating income (the numerator in rate of return) is regulated interest expense (rate base times authorized weighted average cost of debt). Likewise, there is a relationship between the denominator in rate of return (rate base) and the denominator in ROE (equity invested in rate base which is rate base times the authorized equity ratio). Consequently, authorized rate of return and ROE bear a direct relation to one another.

Lines 1 through 3 on Exhibit No. ___(DAD-5) demonstrate this relationship when there is no earnings sharing. Line 3 demonstrates that, on average across all over- and under-earning scenarios, the average actual ROE equals the authorized ROE of 9.80 percent. Lines 6 through 8 illustrate PSE and NWEC's proposal by showing that, when the earnings sharing begins after 25 basis points above the authorized rate of return, PSE can still earn very close to its authorized ROE of 9.80 percent on average, as shown on line 8.

Ultimately, beginning earnings sharing after 25 basis points does not significantly prevent PSE from earning the authorized ROE on average, however, earnings sharing beginning at the authorized rate of return clearly alters the upside and downside parity around the opportunity to earn the authorized ROE. This results in an asymmetrical earnings profile, biased to the downside, that, all else being equal, increases PSE's risk profile. Ultimately, as demonstrated on lines 11 through 13 of Exhibit No. ___(DAD-5), the earnings sharing that begins immediately after PSE's rate of return ceiling is breached creates the more pronounced asymmetrical earnings profile referred to above. As demonstrated on line 13, column I of Exhibit No. ___(DAD-5), the 50 percent earnings sharing that begins above a rate of return of 7.77 percent results in a 14 basis point reduction to PSE's average ROE, using the assumptions in the example provided.

Q. Should the asymmetry on PSE's earning profile due to the earnings sharing approved in Final Order No. 07 be taken into consideration when setting PSE's ROE?

A. Yes. The asymmetrical earnings profile imposed by sharing earnings without a dead band on the upside, increases PSE's financial risk. Therefore, a premium to PSE's ROE should be considered as a direct offset to any ROE reduction that other parties may propose. Furthermore, as demonstrated in Dr. Morin's testimony, 9.80 percent ROE was at the low end of range of reasonableness during the first half of 2013. Therefore the Commission should consider restoring the 25 basis point dead band in the sharing mechanism as originally proposed by

PSE and NWEC to restore parity to PSE's earnings profile and its opportunity to earn its allowed rate of return on balance over time.

VI. IMPACTS OF DECOUPLING ON COST OF CAPITAL

Q. What did the Commission decide in Order 07 with respect to the impact of decoupling on cost of capital?

A. In its decision, the Commission noted that "there is no empirical evidence in the record demonstrating" the effect of decoupling on PSE's cost of capital, including its ROE.[5] The Commission went on to say that

> [e]ven if PSE's bond ratings improve in response to our approval of decoupling and reduce the Company's cost of debt, this effect will occur only prospectively. Experience going forward with decoupling in place for PSE as various of its debt instruments mature over the next several years will provide valuable information to the Commission. This information may support a reduced cost of capital, or adjustments to PSE's capital structure, at the time of the Company's next general rate case.
>
> Similarly, at the time of PSE's next general rate case, parties may bring forth evidence showing that equity markets do, in fact, respond to the implementation of decoupling in the case of publicly traded companies. If the companies are sufficiently similar to PSE to be included in a proxy group when determining cost of equity using traditional approaches, then the Commission might have a sustainable basis for adjusting PSE's cost of equity.[6]

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5 Order 07 at ¶ 103; *see also id*. at ¶ 104.

6 *Id*. at ¶¶ 105 and 106.

Q. Should the Commission evaluate the impact of PSE's decoupling mechanisms on cost of capital in this remand proceeding?

A. No. The Commission should not evaluate the impact of PSE's decoupling mechanisms on cost of capital in this remand proceeding. This remand proceeding is primarily focused on the information that was available to the Commission in the first half of 2013. As the Commission stated, any reduction in the cost of debt would occur only prospectively, which is why the Commission contemplated waiting for PSE's next general rate case to evaluate the effects of decoupling on cost of capital.

Moreover, it has only been 16 months since PSE's decoupling mechanisms went into effect. There has been insufficient time to draw any clear conclusions as to the effects, if any, of PSE's decoupling mechanisms on PSE's cost of capital. Indeed, as noted above, the Commission appeared to contemplate waiting to allow sufficient time for data and results accumulation to evaluate this potential effect.

Q. If the Commission decides to consider the effects of decoupling on cost of capital at this time, what information should the Commission consider?

A. If the Commission decides it is appropriate at this time to consider the effects of decoupling on cost of capital, the Commission should consider the studies undertaken by the Brattle Group, as discussed in the Prefiled Direct Testimony of Dr. Michael J. Vilbert. As Dr. Vilbert discusses, there is no empirical evidence that decoupling lowers the cost of capital, and commissions have overwhelmingly elected not to lower return on equity when decoupling is implemented.

Q. What other evidence may the Commission consider in evaluating the effects of PSE's decoupling mechanisms on PSE's risk?

A. The Commission may evaluate the magnitude of the reduction in revenue volatility due to PSE's decoupling mechanisms.

Q. Understanding that there is only limited history at this point in time, what decoupling revenue adjustments have been recorded by PSE since the Commission approved PSE's decoupling mechanisms?

A. Please see Exhibit No. ___(DAD-6) for decoupling revenue adjustments that PSE has recorded for PSE's electric and gas decoupling mechanisms over the period July 2013 to June 2014. This was the first full year of the operation of these two mechanisms. The results in Exhibit No. ___(DAD-6) show that PSE recorded approximately $9.7 million and $4.7 million in revenue adjustments for the electric and gas mechanisms, respectively.

Q. What portion of these revenue adjustments is attributable to the effects of weather?

A. Please see Exhibit No. ___(DAD-7) for the effects of weather on PSE's electric and gas decoupling mechanisms over the period July 2013 to June 2014. Lines 15 and 33 on page 2 of Exhibit No. ___(DAD-7) show that weather is responsible for approximately $2.7 million and $13.5 million of PSE's electric and gas decoupling revenue adjustments, respectively, over this period.

Q. Should the effects of weather that is absorbed by PSE's decoupling mechanisms be considered in the context of determining PSE's ROE?

A. No. The effects of weather that is absorbed by PSE's decoupling mechanisms should not be considered in the context of determining PSE's ROE. Indeed, in the short term, the effects of weather on utility revenues can go either way. Customers can benefit under decoupling if weather is colder than normal causing increased usage in the cold weather months, and PSE can benefit if weather is warmer than normal. Equity and debt investors take a longer view that over the long term, the effects of weather on utility revenues will cancel out or be averaged away over time. Thus, over time, the portion of decoupling revenue adjustments attributable to weather has no material long-term effect on utility revenues or cash flows and can be disregarded in terms of assessing any impacts on cost of capital.

Q. What portion of the decoupling revenue adjustments are not related to weather?

A. Referring to Exhibit No. ___(DAD-7), the portion of decoupling revenue adjustments unrelated to weather are approximately $7.0 million and negative $8.9 million for the electric and gas mechanisms, respectively. In other words, excluding the effects of weather, PSE reduced overall gas revenues by $8.9 million through negative decoupling revenue adjustments and increased overall electric revenues by $7.0 million.

Overall, the combined net effects of PSE's electric and gas decoupling mechanisms over this period of time—excluding the effects of weather—was approximately a $1.9 million refund to customers. This represents: (i) 0.06% of total electric and gas revenues; (ii) 0.03% of total electric and gas rate base; and (iii) 0.35% of total electric and gas operating income. Based on this analysis, it is reasonable to conclude that decoupling has not had a significant impact on PSE's overall results of operation in its first year of operation and any impact on PSE's cost of capital is not significant at this time. Clearly, as the Commission suggested, more time and data is needed before any definitive conclusions are reached related to the factually sustained effects of decoupling, if any.

Q. Which common rate mechanisms have a greater impact on utility risk profiles?

A. Energy supply risk mitigation mechanisms (e.g., power cost adjustment mechanisms or purchased gas adjustment mechanisms) have a far greater impact on utility risk profiles, both due to the greater volatility inherent in energy supply costs and due to the sheer magnitude of these costs relative to utilities' overall revenue requirements.

Q. How common are these types of rate mechanisms?

A. These rate mechanisms are very common. In fact, as discussed in the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ___(MJV-1T), 100% of the proxy companies used by Dr. Morin's cost of capital analysis has a subsidiary utility with an approved energy supply risk mitigation mechanism.

Q. Do any of these proxy companies also have utilities with approved revenue decoupling mechanisms?

A. Yes. As discussed in the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ___(MJV-1T), a majority of the proxy companies used in Dr. Morin's cost of capital analysis have subsidiaries with decoupling mechanisms. Accordingly, the cost of capital effects from alternative forms of ratemaking such as decoupling are already embedded in the cost of capital information that comprised the peer groups in Dr. Morin's testimony.

Q. Please summarize why the Commission should disregard the hypothetical effects of PSE's decoupling mechanisms on PSE's cost of capital in this proceeding.

A. Certainly. The Commission appropriately determined in Order 07 that it should wait until PSE's next general rate case in 2015-2016 to evaluate the actual effects of decoupling on cost of capital, rather than prospectively adjust cost of capital based on hypothetical effects that decoupling <u>may</u> have on cost of capital.

If the Commission elects to change its approach and further consider this issue in the remand proceeding, the Commission should not adjust PSE's cost of capital for the following reasons:

(i) As Dr. Vilbert testifies, capturing and observing the effects of decoupling on cost of capital remains elusive in a statistically-significant sense, and even if such effects could be captured and observed with statistical significance, it is not possible based on studies performed to date to factually and accurately isolate the effects on the cost of debt from the cost of equity.

(ii) In their first year of operation, PSE's decoupling mechanisms have only resulted in a net change to revenue of $1.9 million after isolating the effects of weather. While this impact on PSE's results of operations is not significant at this time, more history is required to draw any firm conclusions from these results.

(iii) Given the multitude of risk reducing rate mechanisms reflected in the cost of capital data for the peer group in Dr. Morin's study, it is reasonable to conclude that any additional adjustment to ROE in this proceeding would constitute double-counting.

(iv) Even though PSE's decoupling mechanism smooths the volatility related to weather over time, those same weather effects average or cancel out over time. The effects of weather on revenue, operating income and cash flows over time will not be materially different when comparing results of operations from a regime that employs decoupling versus one that does not.

VII. CONCLUSION

Q. Does this conclude your prefiled testimony?

A. Yes.