Service Date: July 8, 2020

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, Respondent.	DOCKETS UE-190529 and UG-190530 (*consolidated*) FINAL ORDER 08
In the Matter of the Petition of PUGET SOUND ENERGY For an Order Authorizing Deferral Accounting and Ratemaking Treatment for Short-life IT/Technology Investment	DOCKETS UE-190274 and UG-190275 (*consolidated*) FINAL ORDER 05
In the Matter of the Petition of PUGET SOUND ENERGY For an Order Authorizing Deferred Accounting associated with Federal Tax Act on Puget Sound Energy's Cost of Service	DOCKETS UE-171225 and UG-171226 (*consolidated)* FINAL ORDER 03
In the Matter of the Petition of PUGET SOUND ENERGY For an Order Authorizing the Accounting treatment of Costs of Liquidated Damages	DOCKETS UE-190991 and UG-190992 (*consolidated)* FINAL ORDER 03 REJECTING TARIFF SHEETS; AUTHORIZING AND REQUIRING COMPLIANCE FILING

conclusion of this case.[39] Rates set in this proceeding thus will likely be effective for a relatively brief period of time, which also weighs against the need for an attrition adjustment. Accordingly, given the totality of these circumstances and options, we determine that an attrition adjustment is unnecessary.[40]

2. COST OF CAPITAL

81 No Parties contest PSE's proposed capital structure, which includes 48.5 percent equity and 51.5 percent debt. The only contested issue related to cost of capital is the appropriate level for PSE's return on equity (ROE). Table 1, below, illustrates the positions of parties that have performed cost of capital analyses.

Table 1 - Cost of Capital Positions

Component	PSE	Staff	Public Counsel and Nucor Steel
Short-Term Debt	2.47%	2.47%	2.38%
Long-Term Debt	5.51%	5.57%	5.51%
ROE	9.50%	9.20%	8.75%
ROR	7.44%	7.29%	7.07%

82 In the Company's initial filing, PSE witness Morin argues the Commission should increase PSE's ROE from 9.50 to 9.80 percent, and that adopting a lower ROE would increase costs for ratepayers because it would lead to an over-reliance on debt, thereby increasing the utility's debt-to-equity ratio, which in turn drives up the cost of equity and the cost of debt.[41]

83 On rebuttal, Morin updates the six models presented in his direct testimony with more recent stock prices and interest rates, showing that the simple average of each model

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[39] Piliaris, TR 246:5-8

[40] Disallowing the attrition adjustment renders moot multiple adjustments contested by Public Counsel.

[41] Morin, Exh. RAM-1T at 5:13-7:6.

results in an ROE of 9.30 percent. Morin then points out that if the lowest result (from a Discounted Cash Flow, or DCF, model) is removed, the average result is 9.50 percent.[42]

84 Morin relies on three models to support his recommendation: DCF, Capital Asset Pricing Model (CAPM), and Risk Premium methodologies.[43] Morin uses a constant growth DCF model, a CAPM analysis, and an empirical approximation to the CAPM (referred to as the ECAPM).

85 For the proxy group, Morin utilizes a combined group of investment-grade, dividend-paying gas and electric utilities covered in Value Line's Electric Utility Composite.[44] Morin testifies that all the proxy utilities earn the majority of their revenues from regulated utility operations, are investment-grade, and pay dividends.[45]

86 Staff recommends an ROE of 9.2 percent, with a range of 8.9 to 9.5 percent based on the upper end of the result range for the DCF model and the mid-point of the range of results for the Comparable Earnings (CE) model.[46] Staff witness Parcell calculates results for three models: DCF, CAPM, and CE. However, Parcell does not give the CAPM result any weight in his quantitative consideration of ROE because he considers it to be an anomaly. Parcell does, however, use the CAPM results to guide his recommendation.[47]

87 Parcell uses both Staff's and Morin's proxy groups. Parcell used criteria similar to Morin's to select Staff's proxy group, which consists of a combination of electric and gas-electric utilities. [48] Parcell explains that it is Staff's practice to also run the utility witness's proxy group, and that Staff's conclusions and recommendations are based upon the results of both proxy groups.[49]

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[42] *Id.* at 92:1-3.

[43] *Id.* at 5:1-5, 5:8-10.

[44] *Id.* at 5:1-5. Morin states that all of the Companies in PSE's Proxy are investment-grade and are paying dividends.

[45] *Id.* at 5:5-7.

[46] Parcell, Exh. DCP-1T at 4:12-15.

[47] *Id.* at 4:12-15.

[48] *Id.* at 24:17-25:2.

[49] *Id.* at 25:10-11.

88 Though Parcell's DCF results for Staff's two proxy groups range between 6.3 and 8.9 percent, Parcell recommends a range of 7.8 to 8.9 percent (8.35 percent mid-point) for the current DCF-derived ROE from Staff's proxy groups.[50] Considering the results of Staff's models, Parcell considers the recommendation to be conservative (*i.e.,* high side).[51]

89 Parcell produces, but then dismisses the weight of, the CAPM results used to make Staff's ROE recommendation. Parcell explains:

> [E]ven though the CAPM results have not been given weight in developing my recommended ROE range, they should be considered as one factor in determining where, within the recommended range, the cost of equity for PSE should fall. Therefore, I recommend that PSE's ROE be set at no higher than the mid-point of the ROE range for the proxy companies.[52]

90 Public Counsel recommends an ROE of 8.75 percent with a range of 6.9 to 8.95 percent, noting that Public Counsel's recommendation is in the upper end of the range. Public Counsel witness Woolridge argues that Parcell's ROE recommendation does not accurately reflect the results of his own ROE analysis, and that Parcell overstates Staff's "results of the DCF analysis by reporting DCF results that only include the single, high DCF growth rate."[53] Woolridge further asserts that Parcell ignores the results of his own CAPM study, which show a much lower ROE for PSE.[54] Finally, Woolridge argues that Parcell's analysis relies completely on his CE approach, which suffers from being "a model of his own creation and interpretation."[55]

91 Woolridge applies the DCF model and CAPM methodologies to three proxy groups:[56] a proxy group of publicly-held electric utility companies, Morin's proxy group, and a

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[50] *Id.* at 29:10-18.

[51] *Id.* at 29:17-18.

[52] *Id.* at 39:19-23.

[53] Woolridge, Exh. JRW-13T at 2:16-1.

[54] *Id.* at 3:1-2.

[55] *Id.* at 3:2-8.

[56] Woolridge, Exh. JRW-1T at 4:4-7.

proxy group of nine natural gas distribution companies.[57] Woolridge develops Public Counsel's electric proxy group using criteria similar to that used by Morin and Parcell.[58]

92 Public Counsel's recommended ROE relies primarily on the DCF model.[59] Woolridge performs a CAPM study but gives its results less weight because Public Counsel believes "that risk premium studies, of which the CAPM is one form, provide a less reliable indication of equity cost rates for public utilities."[60]

93 On rebuttal, Morin argues that Woolridge's recommendation is more extreme than Staff's, that it falls outside the reasonable limits of probability, and that it contains numerous flaws and contradictions. First, Morin argues that Woolridge's 8.75 percent ROE recommendation is well below ROEs "authorized by state utility commissions in 2018 and 2019, which average 9.6 percent" and would harm "PSE's credit ratings, financial integrity, and ability to raise capital."[61] Second, Morin argues that Woolridge relies on a single methodology, the DCF, to support Public Counsel's recommendation and uses questionable inputs in the DCF model.[62] Third, Morin argues Woolridge's DCF growth rate is "arbitrary, contradictory, and inconsistent with several statements in his testimony."[63] Morin concludes that Public Counsel's analysis "should be given little, if any, weight in the Commission's considerations."[64]

94 Morin agrees with several, but not all, of Parcell's methodologies. Morin considers one of Parcell's market risk premiums and beta estimates to be reasonable, but nevertheless concludes that the Commission should give little weight to Parcell's CAPM results.[65]

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[57] *Id.* at 13:8-11. Woolridge's gas proxy group includes Atmos Energy, Chesapeake Utilities, New Jersey Resources, NiSource, Inc., Northwest Natural Gas Company, ONE Gas, Inc., South Jersey Industries, Southwest Gas, and Spire.

[58] *Id.* at 12:1-11. The electric proxy group includes 30 companies.

[59] *Id.* at 25:10-16.

[60] *Id.* at 25:14-16.

[61] Morin, Exh. RAM-12T at 5:1-16.

[62] *Id.* at 5:17-20.

[63] *Id.* at 5:10-7:3.

[64] *Id.* at 8:3-7.

[65] *Id.* at 78:1-5, 79:4-6, 77:1-2.

95 On rebuttal, Doyle argues that this GRC filing is critical to restoring cash flow due to the negative impacts of tax reform,[66] and that Staff's and Public Counsel's recommendations would have a negative impact on PSE's credit metrics.[67] Finally, Doyle argues that "the weighted-average returns on equity proposed by Commission Staff and Public Counsel do not provide an appropriate balance between safety and economy."[68]

96 In its brief, PSE argues that Staff's proposed ROE is understated and based on flawed analyses, and that Public Counsel's proposed ROE is so extreme that it should be disregarded completely.[69]

97 Staff argues in its brief that its recommended ROE is appropriate for current market conditions in which interest rates are extraordinarily low and trending downward. As such, Staff argues that the Commission should decline PSE's request to maintain the same ROE approved in the 2017 GRC in light of the significantly different circumstances presented in this proceeding. Staff also observes that PSE's analysis produces an ROE of 9.25 percent rather than 9.46 percent when Morin's DCF Analyst Growth Methodology results are properly included, and argues that Morin fails to explain why the DCF Analyst Growth Methodology results, 8.2 percent, are excluded as an outlier.

98 Staff recommends the Commission also reject PSE's proposal to update the marginal short-term debt rate in its compliance filing because the Commission would not be able to calculate the ROR or the revenue requirement until after entering its final order. To avoid this outcome, Staff recommends the Commission incorporate the 2.47 percent short-term cost of debt reported in response to BR-11 into PSE's final ROR. In its reply brief, PSE accepts Staff's proposal to use the short-term cost of debt of 2.47 percent.

99 TEP also supports a reduction in PSE's ROE, arguing that "Morin concedes that the overall average of his results is 9.3 percent, just slightly above Staff's recommendation. He only arrives at his 9.5 percent recommendation by excluding the lowest DCF result from his calculation while including both estimates at the high-end of his range. The mid-

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[66] Doyle, Exh. DAD-7T at 36:14-18.

[67] *Id.* at 37:3-4, 38:2-4.

[68] *Id.* at 38:7-8.

[69] PSE Initial Brief ¶¶ 54-56.

point of his range (8.2 - 10.2 percent) is 9.2 percent, also directionally consistent with Staff and Public Counsel."[70]

100 Public Counsel argues that PSE's requested ROE of 9.5 is excessive because capital markets remain at low levels and PSE's short-term debt and equity cost rates are out of date. Public Counsel contends that its recommended 8.75 percent ROE appropriately reflects the downward trend in utility authorized and earned ROEs. Despite the lower ROEs, Public Counsel asserts, credit profiles for those utilities have not been impaired, they have been able to collectively raise more than $50 billion per year in capital, and utility stock prices have performed right along with the S&P 500.[71]

101 Finally, Nucor Steel supports Public Counsel's analysis and recommendations and requests the Commission approve an ROE of 8.75 percent.[72]

Commission Determination

102 The expert witnesses for each party rely on familiar analytical tools such as DCF and CAPM models, and use a variety of data sources to populate these and other models to calculate and support their respective ROE recommendations. As we have noted in many past proceedings, the results produced by each model vary significantly due to subjective judgments each expert makes with respect to their individual approaches and inputs. For example, all three experts in this proceeding arrive at ROE results ranging widely from 3.8[73] to 10.2[74] percent, a difference of more than 600 basis points. The disparity in outcomes is directly attributable to the experts' selection of proxy groups and their reliance on different sources for growth rates, discount rates, and risk premiums. While the expert witnesses' analyses produce a range of possible returns, the 600-plus basis point disparity suggests that both the lower and higher results are outside the zone of reasonableness, which typically falls within a narrower range. Considering all of the expert witnesses' analytical results and industry trends during recent periods, we

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[70] TEP Initial Brief ¶ 59.

[71] Public Counsel Initial Brief ¶ 20.

[72] Nucor Steel Reply Brief ¶ 4.

[73] Public Counsel's low-end CAPM result.

[74] PSE's high-end Allowed Risk Premium Result.

determine that Staff most appropriately identifies a reasonable range between 8.9 and 9.5 percent.

103 With respect to the parties' specific ROE recommendations, we share Staff's concern that PSE excludes Morin's DCF Analyst Growth Methodology result, 8.2 percent, as an "outlying result" with no further explanation.[75] Presumably, Morin considers this number an outlier because it is the lowest of the six ROE results used in his calculation. Notably, Morin did not afford similar treatment to the highest of the six ROE results. Such inconsistency is not reasonable.

104 The average of all six of Morin's ROE results produces an ROE of 9.25 percent (which Morin rounds up to 9.3 percent) when Morin's DCF Analyst Growth Methodology results are properly included. When both the highest (10.2 percent) and lowest (8.2 percent) results are excluded, the average of the remaining four ROE results produces an ROE of 9.28 percent. Although PSE recommends we authorize its current ROE of 9.5 percent, PSE offers no analysis to support that result. Absent PSE's unsupported 9.5 percent ROE, the record supports a range of reasonableness set by parties' recommendations between 8.75 percent and 9.28 percent.

105 We rely on both the range of reasonableness and the parties' recommendations to inform our decision. We are also cognizant that the midpoint of the range of reasonableness – 9.2 percent – is 30 basis points below PSE's currently authorized ROE. A reduction of that magnitude, under current conditions, would run afoul of the principle of gradualism. As we noted in Avista's 2017 GRC:

> When considering changes to a regulated utility's authorized ROE, we endeavor to avoid material adjustments, upward or downward, in authorized levels to provide stability and assurance to investors and others regarding the regulatory environment supporting the financial integrity of the utility. Based on the evidence produced by the various expert witnesses, we generally determine whether modest increases or decreases, if any, to

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[75] Morin, Exh. RAM-12T at 92:2.

> currently authorized levels are appropriate given the evidence produced in the immediate proceeding.[76]

106 Here, the detailed analyses presented in the record suggest that a more modest decrease is appropriate. Giving weight to all of the expert's recommendations but appropriately incorporating the principle of gradualism, we determine that an ROE of 9.4 percent is reasonable and fully supported by record evidence.

107 In addition, the Commission recently approved an ROE of 9.4 percent for three other Washington utilities, which we have found strikes an appropriate balance between the lower risk of utility investment and regulated companies' ability to attract investors in an economic environment where interest rates are low.[77]

108 The Commission, therefore, approves an ROE of 9.4 percent. Based on that ROE, the uncontested hypothetical capital structure, and the uncontested cost of debt, we approve and adopt an overall ROR of 7.39 percent for purposes of establishing electric and natural gas revenue requirements and rates in this proceeding.

3. REVENUE REQUIREMENT – CONTESTED ADJUSTMENTS

i. Pro Forma Capital Additions

109 In its initial filing, PSE proposes numerous pro forma adjustments, including five major projects: Get to Zero Program (GTZ), Advanced Metering Infrastructure (AMI), Data Center and Disaster Recovery Program (DCDR), Tacoma LNG Distribution Upgrade, and SmartBurn. PSE proposes a pro forma capital additions cutoff date of June 30, 2019, and a materiality threshold that includes any adjustment that "impacts the rate of return

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[76] *See Wash. Utils. and Transp. Comm'n v. Avista Corp., d/b/a Avista Utils.,* Dockets UE-170485 and UG-170486 (*Consolidated*), Final Order 07 ¶ 68 (Apr. 26, 2018).

[77] *See Wash. Utils. and Transp. Comm'n v. Avista Corp., d/b/a Avista Utils.,* Dockets UE-190334, UG-190335, and UE-190222 (*Consolidated*), Final Order 09 (Mar. 25, 2020), approving settlement that set Avista's ROE at 9.4 percent; *Wash. Utils. and Transp. Comm'n v. Cascade Natural Gas Corp.,* Docket UG-190210, Final Order 05 (Feb. 3, 2020), approving settlement that set Cascade's ROE at 9.4 percent; and *Wash. Utils. and Transp. Comm'n v. Northwest Natural Gas, d/b/a NW Natural,* Docket UG-181053, Final Order 06 (Oct. 21, 2019), approving settlement that set NW Natural's ROE at 9.4 percent.