EXH. TAS-1T
DOCKETS UE-240004/UG-240005
2024 PSE GENERAL RATE CASE
WITNESS: TODD A. SHIPMAN

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent**	**Docket UE-240004** **Docket UG-240005**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

TODD A. SHIPMAN, CFA

ON BEHALF OF PUGET SOUND ENERGY

FEBRUARY 15, 2024

PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Please state your name and business address.

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

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

A. Yes. Please see Exh. TAS-2.

Q. What are your current professional activities?

A. After retiring from S&P Global Ratings ("S&P"), I became a management consultant specializing in advising utilities and other entities on credit and ratings issues, balance sheet management, and capital markets strategies. I was also an adjunct faculty member in Boston University's Questrom School of Business, where I taught advanced undergraduate courses in corporate finance and capital markets.

Q. What are your qualifications as an expert witness on credit rating matters?

A. I spent over 20 years at S&P, a major ratings agency that has been in business over 150 years and issues more than one million ratings on over $46 trillion of debt across all global capital markets. I am qualified to opine on utility credit quality and ratings because of the degree and scope of my involvement in rating utilities and other energy companies over many decades. In the final decade or so, I was the Sector Specialist on the North American utilities team. In that role, I was the lead analyst charged with ensuring ratings quality and the training and development of new analysts. I also chaired a vast majority of the rating committees conducted over more than a decade. The chairperson role is critical to achieving effective committee deliberations and assuring a fully vetted ratings opinion. Along with the primary analyst, the chairperson has the most influence over the ratings that emerge from each committee.

I was the primary analyst on over 150 different issuers during my time at S&P. Between the two roles, my work had a direct effect on the ratings of every investor-owned utility in the U.S. and Canada over the course of decades, and therefore the rates of a majority of electricity customers in North America. During this time S&P comprehensively revised and updated its corporate ratings criteria, and I led the effort in creating the criteria used to establish ratings on all utilities across the globe. I was also responsible for outreach efforts to investors and the regulatory community. As an analytical leader in corporate ratings and later infrastructure/project finance ratings, I was involved in many cross-sector ratings

activities. For instance, I performed a lead analytical role in the development and application of global ratings criteria for hybrid capital securities such as preferred stock.

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

A. Credit ratings provide a valuable benchmark for utility regulators to assist in their decision making by offering an objective perspective on a utility's risk profile over a long-term time horizon. Ratepayers have an interest in a well-managed utility risk profile because it directly affects the cost of service that they bear, most directly in the cost of capital but also throughout a utility's operations. A full understanding and acknowledgement of the importance of credit ratings, including the factors that affect ratings and the significant effect that regulatory decisions and behavior have on ratings, will assist the stakeholders in this proceeding achieve an outcome that will benefit ratepayers now and in the future.

PSE's credit profile and ratings are stable but under pressure because of cash-flow deficiencies and increasing financial burdens from the state policy to transition to a clean energy future for Washington. Rating agencies and investors expect the Washington Utilities and Transportation Commission ("WUTC" or "Commission") to follow through on the progress made in the previous rate case decision by adopting the proposed multiyear rate plan ("MYRP") supported by an authorized return and capital structure that enable PSE to attract capital on reasonable terms. The requested returns, augmented by several proposals to better

equip PSE to reliably achieve those returns by reducing regulatory lag, will stabilize PSE's credit profile and ratings to the benefit of ratepayers.

II. CREDIT RATINGS AND CAPITAL MARKETS

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

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

In a broader sense, credit ratings reflect a more comprehensive view of financial health than other, more familiar financial measures such as quarterly financial results, earnings per share, rate of return for a particular reporting period, or the market prices of a company's securities. Ratings are also an independent opinion offered by firms that have no financial stake in the outcome of their analyses. The *long-term* and *independent* nature of credit ratings makes them an ideal benchmark to assist utility regulators as they navigate the many decisions they must make as they balance competing interests. I have found that as disinterested observers with a long-term mindset, rating agencies are well aligned with the perspectives of regulators.

Q. What does a credit rating agency do?

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

As depicted in the ratings scale exhibit, ratings in the BBB/Baa category and above are considered "investment-grade" by market participants. Ratings below BBB-/Baa3 are known as "speculative-grade," or colloquially "junk," securities. Because a significant number of prominent and active investors are precluded from holding speculative-grade issues, the difference between investment-grade and speculative-grade ratings is profound and is recognized as such by rating agencies and market participants. The notch between BBB- and BB+ is more of a chasm than a step.

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

A. Yes. The risk of default is a good proxy for overall risk and an issuer's financial strength. The default experience of issuers validates the usefulness of credit ratings as a measure of risk. According to Moody's, from 1994 through 2022 the five-year average, volume-weighted corporate bond default rate generally increases from one rating category to the next lower one in the ratings scale, from a low of 0.0% for the Aaa category to 36.8% for the combined "Caa-C" categories. The overall difference between the investment-grade and speculative-grade categories is stark: 0.6% versus 12.2% in the same five-year period.[1] In other words, the risk to investors increases as you go down the rating scale and is markedly different once you leave the investment-grade categories. This track record is the main reason investors pay attention to credit ratings and why some avoid companies that are not investment-grade. Ratings have proven to be a reliable and transparent measure of risk over a long period of time.

Q. Who uses credit ratings?

A. Investors consult them when making investment decisions on choosing companies for investment and the price that they will demand to lend to or invest in a company. Ratings are valuable to investors because they are based on a consistent

[1] *See* Moody's Investor Service, Sector-In-Depth, *Default Trends – Global, Annual Default Study: Corporate Default Rate Will Rise in 2023 and Peak in Early 2024*, at Exh. 46 (Mar. 13, 2023), available at Exh. TAS-4C.

approach to assessing risk across time. Investors generally fall into two basic categories with distinct risk appetites. Fixed-income investors (*e.g.*, lenders or bondholders) extend capital to a company in exchange for a fixed return and the obligation to be repaid the original investment. Equity investors (*i.e.*, stockholders) receive only a residual return after all expenses are paid with no ability to demand a return of the investment. Fixed-income investors use ratings as one, very important consideration when deciding whether, and at what cost, to lend capital to a utility. Both fixed-income and equity investors use the credit analyses performed by rating agencies to help them understand the overall risk of an issuer.

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

A. Credit ratings directly affect the cost of capital needed for investment and, thereby, drive overall customer rates.[2] Fixed-income investors and other creditors use ratings to assist them in determining the price they will charge the utility for the use of their money. The total price is the combination of the interest rate of the instrument and its initial value in relation to the stated amount on the instrument. There is an inverse relationship between debt cost and ratings: the higher the rating, the lower the cost. Equity investors (i.e., stockholders) also use credit ratings as a risk guide to help them decide when and at what price they will offer their capital to a utility. The more risk they detect, the greater return they will

[2] Charles F. Phillips, Jr., *The Regulation of Public Utilities* (3d ed. 1993), at 250, available at Exh. TAS-4C.

require to compensate them for bearing that risk. The effect is not as direct or precisely quantifiable as it is with fixed-income instruments, but in my experience equity investors often take notice of credit ratings and react to ratings upgrades and downgrades.

Q. How is a credit rating determined?

A. The process begins with the preliminary credit assessment of the issuer. The primary analyst evaluates the creditworthiness as the first step and continually refines the evaluation as the process unfolds. The next step is meeting with the issuer's management to assess their effect on credit quality and elicit more information that is not always accessible from securities filings and other public sources. The primary analyst conducts the meeting with the assistance of senior analysts on the team. They question and challenge management to understand their commitment to credit quality, their grasp of business operations and financial matters, and their views of future strategy, capital plans, and financial policies that could affect creditworthiness. After analyzing the credit profile and incorporating the insights gleaned from the management meeting and follow-up interactions, the ratings process culminates in a rating committee.

Q. What is the role of the rating committee?

A. Ratings are established by a committee of analysts that specialize in the industry or industries of the rated entity. When warranted, other analysts with relevant expertise in other areas needed to accurately assess the risk of an issuer will

participate in the committee. Ratings conform to common standards of credit risk across all issuers, industries, and markets by employing consistently applied ratings criteria. The committee first decides on the issuer credit rating, which corresponds to the fundamental credit quality of the entity before any legal and structural considerations that inform the ratings on specific issues. The committee then assigns ratings to the various rated debt or other securities in the capital structure. After the committee has made its decisions, they are communicated to the public by publishing and disseminating the credit opinion. The process then returns to the beginning as the issuer and its ratings are placed under constant surveillance.

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

A. The analysis is fundamentally an examination of two, independent risk measurements that when combined sum to total credit risk. The *quantitative* side of the analysis develops financial ratios and other metrics to analyze the financial risk of the issuer. The *qualitative* side is the assessment of business risk, which is built up from the broad macro risks at the country and industry level. After the broad risk environment is determined, the committee establishes the issuer's individual business risk within that business and economic environment.

Business risk and financial risk are best understood as complementary measures of the total risk of an entity. For example, two utilities, Utility A and Utility B, may have the same credit rating, but Utility A may have more business risk than

Utility B. In such a situation, one would expect Utility A to have less financial risk to arrive at a particular rating. Because utilities are tightly regulated on financial matters that limit how much financial metrics can vary over time, I have found that it is more often that qualitative business risk drives ratings outcomes in the utility industry. This finding is supported by more than my experience. The utility credit analyses at Moody's and S&P are both designed to stress business risk over financial risk considerations when arriving at a rating. Moody's is explicit in this bias, as the weighting in their scorecard for utilities is a 60%/40% split between business and financial factors.[3]

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

A. For a utility, the main business risks are regulatory risk, operating risk, and cash flow diversity, but the first, regulatory risk, is *the* major factor in the analysis. Evaluating regulatory risk almost invariably circles back to cost recovery, notably full recovery of a utility's cost of capital, including the cost of both debt and equity, through a reasonable authorized return on rate base, that is, the utility's capital investment. The nature and pace of the process of recognizing an incurred cost as recoverable through rates is the paramount business risk factor for a utility credit analyst. The other elements of regulatory risk, such as the political

[3] Moody's, *Rating Methodology*, *Regulated Electric and Gas Utilities*, Sept. 10, 2020, at 4, available at Exh. TAS-4C.

influences on regulation, are analyzed to discern the risk surrounding the ultimate factor of covering all costs sufficiently to earn a reasonable return.

Q. How is regulatory risk analyzed?

A. In the Moody's methodology for utilities, regulatory risk constitutes over 80% of business risk, and for S&P, it is 60%.[4] Each focuses on the basic regulatory framework, including (1) the legal foundation for utility regulation, (2) the ratemaking policies and procedures that determine how well the utility is afforded the opportunity to earn a reasonable return with a reasonable cash component, and (3) the history of regulatory behavior by the governing bodies applying those laws, policies and procedures.

The central question of utility regulation to a utility investor can be summed up in two words: cost recovery. Cost recovery includes the ability to recover the cost of capital (a large cost item for a utility) through a reasonable return on equity. But, cost recovery is not just *how much*, but *how* that money is recovered. Relevant considerations include whether recovery is predictable and dependable, whether recovery mechanisms create extended lag, whether the regulator is taking timely action on rate requests, and whether all utilities are treated consistently in terms of the regulatory process. The process of recognizing an incurred cost as recoverable through rates is the paramount business-risk factor.

[4] Moody's, *Rating Methodology*, *supra* note 3, at 4; S&P Ratings Direct, Criteria | Corporates | General, *Corporate Methodology: Ratios and Adjustments*, at 22 (Table 12) (July 14, 2023), available at Exh. TAS-4C.

Q. After the overall regulatory framework is analyzed, how is regulatory risk determined?

A. Next, credit rating agencies examine the mechanics of regulation, particularly the rate-setting process and the details of how a utility's rate structure translates into the stability of its cash flows. In the past, rate cases took up much of the analysis, but now, the totality of a utility's tariff and rate structure are assessed to capture the effect on business risk of revenues generated outside base rates set in base rate cases. Formula rates, fuel clauses, and other varieties of rate mechanisms prevail across the utility industry and are the most common kind of rate mechanisms that stabilize earnings and cash flows to the benefit of the business risk profile. Creditors and therefore rating agencies attribute less risk to rate mechanisms that operate outside the rate case cycle and adjust rates automatically, in short time frames or flexible time frames to match revenues with costs, thereby minimizing regulatory lag.

Q. How do the authorized return on equity ("ROE") and capital structure affect a utility's credit rating?

A. These two elements of the revenue requirement calculation will, if supportive, give a utility a better opportunity to earn its actual cost of capital and provide more operating cash flow. Moreover, investors and rating agencies view these items in tandem as indicators of a regulator's attitude toward the utility's providers of capital. The authorized ROE is the most prominent feature of a rate

case decision after the amount of the rate increase or decrease. The authorized ROE reveals the regard that the regulator has toward the investors that are furnishing the capital needed to maintain safe and reliable utility service and achieve other public policy goals. An in-depth analysis of the rate decision is required to fully understand the ratings implications, but the authorized return is widely used by investors to make preliminary judgments about the relative supportiveness of a regulatory jurisdiction. It is therefore an important signaling device to the investment community that affects the cost of capital, both equity and debt, and thus customer utility rates.

Q. Is the authorized ROE the only influential measure of profitability the rating agencies consult to assess regulatory risk?

A. No. A utility's ability to earn the authorized return is as important to credit analysis as the authorized ROE. In the Moody's ratings methodology on the subject of regulatory risk, a section called "Ability to Recover Costs and Earn Returns" addresses "the ability of a utility to recover its costs and earn a return over a period of time, including during differing market and economic conditions." [5] S&P has also highlighted this principle:

> We review authorized returns and capital structures in our analysis, but we focus mainly on actual earned returns. Examples abound of utilities with healthy authorized returns that have no meaningful expectation of earning those returns due to, for example, rate case

[5] Moody's, *Rating Methodology*, *supra* note 3, at 12.

lag (i.e., the relationship between approved rates and the age of the costs used to set those rates) or expense disallowances.[6]

The rating agencies emphasize the difference between authorized and earned returns because both must be analyzed to accurately assess regulatory risk. An authorized ROE that corresponds with the utility's actual cost of common equity capital is just the first step. Realizing that return in cash on a consistent basis is the real test of a regulatory environment. That is why rating agencies devote so much effort to understanding regulatory regimes and ratemaking procedures to determine how they alleviate or impede a utility's ability to manage risk.

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

A. No. Rating agencies also look at the *consistency* and *transparency* exhibited in a regulatory jurisdiction's decisions.[7] Rating agencies rate many types and tenors of fixed income securities, but they regard debtholders who extend credit over long periods as their primary audience. They view their mandate as rating long-term debt as accurately as possible over the longest timeframe as possible. Utilities ultimately fund capital expenditures with long-dated maturities to match the long-lived assets they are supporting, and utility investors (debt and equity holders) expect ratings to be forward-looking and stable. Regulatory frameworks and

[6] S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, Aug. 10, 2016, at 5, available at Exh. TAS-4C.

[7] Moody's, *Rating Methodology*, *supra* note 3, at 4; S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, at 2 (May 18, 2015), available at Exh. TAS-4C.

practices that provide certainty and allow rating agencies to confidently project future cash flows and debt leverage will naturally be accorded a better business risk profile. Regulatory frameworks and practices that are in transition or being questioned and do not allow rating agencies to confidently project future cash flows and debt leverage will be accorded an inferior business risk profile. The predictability that comes from the *consistency* and *transparency* exhibited in a regulatory jurisdiction's decisions offers creditors the ability to assess risk accurately over most of the debt's term and improves the ability of the company to manage its business activities and capital program for the long-term benefit of its customers. Thus, consistency and transparency are hallmarks of a supportive regulatory jurisdiction.

Q. Do regulatory actions only affect the analysis of business risk?

A. No. Regulatory behavior affects both the business risk and financial risk sides of the credit rating equation I have been articulating. The manner of establishing rates and the level and timing of cost recovery has a direct effect on a utility's ability to earn its authorized return on rate base and produce enough earnings and cash flow to support its credit metrics that measure financial risk. A regulatory jurisdiction's approval of a rate mechanism using a fully compensatory rate of return, including a capital structure that offers sufficient risk protection to bondholders and other creditors, is a feature of a credit-supportive regulatory environment that would factor in assessing business risk as well.

Q. What financial considerations underlie the quantitative side of credit rating analysis?

A. Credit rating analysis is distinguished by its emphasis on cash flow. Recognizing that debt is serviced with cash, not earnings, credit analysts strive to understand the cash flow dynamics of a company's financial results as much as or more than the accounting-derived earnings. The most recent example that highlighted this dichotomy is the effect of the Tax Cuts and Jobs Act on utilities, which placed downward pressure on utility ratings because of its negative cash flow impact despite relatively neutral earnings implications. The other major element of financial risk to a credit analyst is the total amount of debt or debt-like obligations on the issuer's balance sheet and from other activities. Items that the rating agency regards as debt-like are underfunded pension obligations, lease liabilities, long-term power purchase obligations, and deferred taxes.

Credit metrics are calculated for both historical periods and future forecasts and fall into two basic types: leverage and coverage ratios. Since ratings are forward-looking, the forecast is given more weight in the analysis. Leverage metrics assess the relative burden of debt and other fixed-income obligations compared to the financial responsibility being carried by shareholders. Leverage is measured against cash flow, for the most part, and represents a longer-term view of credit protection. Because of its long-term perspective, credit analysis tends to emphasize leverage metrics in the assessment of financial risk. Coverage metrics

are something of the opposite, gauging the more immediate question of how cash flow compares to the near-term need to service the fixed-income obligations.

Q. How is cash flow measured in leverage and coverage metrics?

A. The primary measure that rating agencies use as a base for most cash flow metrics is cash flow from operating activities. Moody's calls its preferred cash flow measure "Cash Flow From Operations Before Changes in Working Capital" ("CFO pre-WC"), which removes the effects of transitory changes in working capital from CFO to pinpoint the ongoing ability of an issuer to generate cash flow from its normal operating activities.[8] S&P uses a similar measure, called "Funds-From-Operations," ("FFO"), although for consistency reasons they base their FFO calculation off the more familiar income statement measure of "Earnings Before Interest, Taxes, Depreciation, and Amortization" ("EBITDA"). S&P then removes the actual cash paid for taxes and interest to arrive at a figure that aligns with operating cash flows stripped of the influence of working capital.[9]

Q. What credit metric or credit metrics do credit rating agencies tend to prioritize?

A. FFO/Debt or the Moody's equivalent is the preferred credit metric of utility credit analysts. The leverage measure is more stable and has a more long-term character than the coverage ratios that are given a secondary role in the financial analysis.

[8] Moody's, *Rating Methodology*, *supra* note 3, at 20.
[9] S&P, *Corporate Methodology*, *supra* note 4, at 3.

The conventional leverage metric, debt-to-capitalization, is not regarded as a reliable measure of debt leverage for most corporate issuers, although Moody's does give it a minor weighting for utilities based on the importance of the capital structure in setting utility rates.

Q. Are credit metric benchmarks applied uniformly and strictly?

A. No. Although the evaluation of financial risk appears to be objective, based on "the numbers" as opposed to the more subjective business risk, in practice the application of metric analysis can vary at different times. As a forward-looking analysis, a rating committee can choose to emphasize different metrics over different time frames. Combined with the long-term bias alluded to earlier and the impulse to rate through temporary cycles, credit metric analysis is often dynamic. An example was the dip in cash flows caused by the coronavirus pandemic, which was in some cases viewed as a transient factor that allowed metrics to fall below the normal benchmark threshold without any rating action. The same holds true for financial windfalls that may spike a given metric without any expectation that the improvement is durable. The most recent instance of this phenomenon was the response to the effects of COVID on utilities, but my sense is that the rating agencies are becoming wary of utilities that continually operate on the edge of financial performance expectations.[10]

[10] For instance, S&P's move to a stable outlook on the industry this year included a warning that "[s]ignificant risks for the industry remain, including . . . the practice of many companies to operate with minimal financial cushion from their downgrade thresholds." S&P, *The Outlook for North American Regulated Utilities Turns Stable*, at 1 (May 18, 2023), available at Exh. TAS-4C.

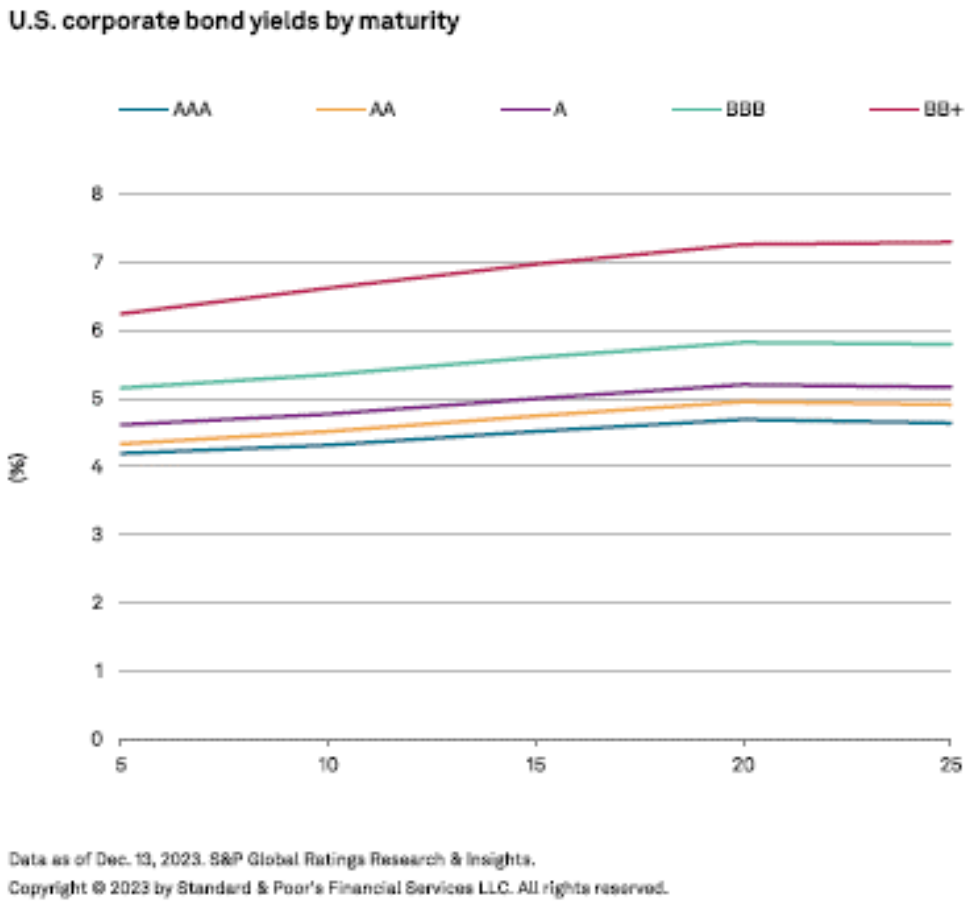
Q. Which side of the credit analysis equation, business or financial risk, most affects utility credit quality?

A. As I noted above, the business risk side is a bit more weighted in the balance of the two when utilities are analyzed, but that really doesn't capture the true dynamic of utility credit quality. Because of the outsized influence of regulation on the industry, which again is the primary factor in assessing business risk, the actions of regulators materialize in the credit analysis in business and financial risks alike, as I mentioned above. This "feedback loop," wherein regulatory decisions act on business risk factors *and* directly affect a utility's ability to manage financial performance, tends to intensify the impact of regulation on ratings outcomes. I cannot stress enough the outsized role that regulators play in determining utility credit quality.

Q. How do credit ratings affect ratepayers?

A. The direct advantage of better ratings is a lower cost of capital, both debt and equity. The equity side is less evident, but equity investors use ratings to help gauge the risk of a company. Below is from a recent report from S&P showing bond yields for U.S. corporate issuers by investment-grade rating category and 'BB+'-rated companies.[11] The chart is instructive, because it demonstrates the inverse relationship between ratings and debt costs.

[11] S&P, Commentary | Credit Trends, *U.S. Corporate Bond Yields As of Dec. 13, 2023* (Dec. 14, 2023), available at Exh. TAS-4C.



Data as of Dec. 13, 2023. S&P Global Ratings Research & Insights.

The second reason to strive for better ratings is less obvious but in my opinion equally valuable to ratepayers. A company and its stakeholders benefit from a healthy cushion from speculative-grade rating categories. The dynamic of rating movements that I have observed over many decades of experience is that downgrades occur much more readily than upgrades. The "stickiness" of a rating after a downgrade, which I think is a natural consequence of the mindset of rating committees made up of analysts who are trained to detect risk and tend to have an innate disposition to the downside. This phenomenon is so manifest that investors

I interacted with would often refer to a company being "in the penalty box" when discussing "fallen angel" ratings.

III. PSE'S RATINGS AND OUTLOOK

Q. What are PSE's credit ratings?

A. Moody's issuer rating on PSE is 'Baa1'.[12] They confirmed the rating and stable outlook in August 2023 following a periodic review.[13] S&P's issuer rating on PSE is 'BBB' with a stable outlook.[14] The fundamental opinions of PSE's creditworthiness are identical, which is reflected in the S&P stand-alone credit profile ("SACP") of 'bbb+'.[15] The SACP is closer to the Moody's approach to rating an issuer with less emphasis on the influence of the corporate structure.[16] In my experience, utility investors look to both evaluations when making investment decisions but place more value on the stand-alone credit quality of the entity they are considering lending money to. The short-term ratings are equivalent ('A-2'/'P-2').

[12] Moody's, *Credit Opinion: Puget Sound Energy Inc.: Update to credit analysis* (Sept. 15, 2023), available at Exh. TAS-4C.

[13] Moody's, *Moody's announces completion of a periodic review for a group of North American Utilities issuers* (Aug. 1, 2023), available at Exh. TAS-4C.

[14] S&P, *Puget Sound Energy Inc*. (May 11, 2023), available at Exh. TAS-4C.

[15] *Id*. at 8.

[16] The SACP is an intermediate determination in S&P's ratings methodology that signifies what an issuer's rating would be absent extraordinary parental support. S&P, *General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating* (Aug. 29, 2022), available at Exh. TAS-4C.

Q. What are the main drivers of the rating agencies' opinions of PSE's credit quality?

A. Moody's affirmed its issuer rating on PSE, 'Baa1', in 2020 following what it described as an "unfavorable" rate case decision,[17] but in its most recent credit report they acknowledge the credit-positive outcome of the most recent rate case.[18] S&P affirmed its ratings in 2021 and changed to a stable outlook based on the promise of less regulatory lag and greater cash flow stability following the enactment of Senate Bill 2521.[19] S&P had reacted to the 2020 rate decision, too, placing the ratings on CreditWatch with negative implications based on the same view of the decision as Moody's.[20] The CreditWatch listing was changed to the more placid negative outlook soon thereafter[21] and, as noted above, returned to stable in 2021. The stable outlook was vindicated by the last rate case outcome, which S&P viewed, like Moody's, as credit-supportive in that multiyear ratemaking "promotes predictability and lowers uncertainty for the utility and its stakeholders."[22] The previous affirmations and the expected stability in the face of regulatory uncertainty were based on analyses that (1) overlooked near-term weaknesses in favor of expectations that the causes of the weaknesses were

[17] Moody's, *Rating Action: Moody's affirms the ratings of Puget Energy and Puget Sound Energy; outlooks stable* (Aug. 25, 2020), available at Exh. TAS-4C.
[18] Moody's, *Credit Opinion, supra* note 12, at 1.
[19] S&P, *Research Update: Puget Energy Inc. And Subsidiary Outlooks Revised To Stable Following New Rate Plan Legislation; Ratings Affirmed* (May 27, 2021), available at Exh. TAS-4C.
[20] S&P, *Research Update: Puget Energy Inc. And Subsidiary Ratings Placed On CreditWatch Negative Over Regulatory Concerns* (July 23, 2020), available at Exh. TAS-4C.
[21] S&P, *Research Update: Puget Energy Inc., Pugent [sic] Sound Energy Inc. Ratings Affirmed; Off CreditWatch On Clarification Order; Outlook Negative* (Aug. 21, 2020), available at Exh. TAS-4C.
[22] S&P, *Puget Sound Energy, Inc*., *supra* note 14, at 2.

transitory and (2) assumed the WUTC would follow through on the credit-positive framework that the legislature has crafted in recent years to ease the transition of the energy infrastructure in the state. The rating agencies are now concentrating on the longer-term issue of the pressure that the energy transformation in Washington is putting on utility credit quality as more capital is required to execute that transformation. Wildfire risk has also captured their attention, most prominently in the case of Moody's.[23]

Q. Are those main ratings drivers tied to business risk factors or financial risk factors?

A. Both, most emphatically. As I pointed out in my overview of ratings above, business risk is more heavily weighted in the credit analysis of a utility, but I see greater attention to financial risk considerations as the rating agencies have gotten more comfortable with Washington utility regulation. I am not denigrating the importance of continued progress in lowering regulatory risk: the Commission should act favorably on PSE's proposals to help manage business risk to underscore rating agency perceptions of an improved Washington regulatory environment. Reducing regulatory lag with progressive ratemaking like new tracker mechanisms for extraordinary initiatives (clean energy, wildfire mitigation, etc.) and construction-work-in-progress ("CWIP") in rate base will

[23] Moody's, *Credit Opinion, supra* note 12, at 2, 6.

reinforce investor perceptions of an improving PSE risk profile.[24] Rating agencies view such risk-reducing ratemaking techniques as very credit-supportive.[25]

However, buttressing those credit-supportive ratemaking mechanisms with authorized returns and capital structures that are at least equal to or better than peers[26] would magnify the risk reduction by improving both business and financial risk. The analyses by PSE witness Doyle on the harmful effect of below-average returns on PSE's ability to attract capital on terms most advantageous to ratepayers is compelling.[27] In my opinion, given PSE's challenges (large capital spending needs relative to its size and growing investor concerns on wildfire risks), PSE and its stakeholders should be targeting returns more on the top quartile of peers rather than struggling in the lowest quartile.

Q. What is the basis for your opinion on the returns and capital structures required to support the PSE credit profile?

A. My conclusion is confirmed by the testimony of PSE witness Peterman and the stated expectations of the rating agencies. As Peterman shows, adopting the authorized returns requested to be phased in during the MYRP along with

[24] Please see the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-1CT, for a discussion of PSE's proposals to improve the timeliness of cost recovery.

[25] S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, supra note 6, at 5-7.

[26] Please see the Prefiled Direct Testimony of Ann E. Bulkley, Exh. AEB-1T, for PSE's proposed return on equity. Please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT, for PSE's proposed capital structure. Please see the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-1CT, for a discussion of PSE's financial proposals in this multiyear rate proceeding.

[27] *See* Third Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-4; *see also* Fourth Exhibit to the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-5.

requested CWIP treatment would gradually restore credit metrics to levels commensurate with the range expected by Moody's.[28] While the Moody's downgrade trigger (19% CFO pre-WC to debt) is still breached, that metric averages above the trigger over the two-year plan and is likely not to elicit a negative rating action. For a discussion of the projected impacts of PSE's financial proposal on credit metrics, please see the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT.

Q. How does this evolution in the ratings and the analyses behind them inform this proceeding?

A. The history over the past few years is a testament to the long-term nature of ratings that I reference as an essential feature of agency opinions on credit quality. The forbearance of Moody's and S&P proved prescient as the MYRP has taken hold and the discomfort about regulatory risk has abated. The point of this overview of the ratings is that progress has been made on reducing regulatory risk but persistence is necessary to keep the momentum going as the focus shifts to the ongoing energy transformation. The burden of the large capital expenditures on PSE and its balance sheet will strain the credit profile.

[28] *See* Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT.

Q. What issues in this case will the rating agencies focus on during their surveillance of the PSE's risk profile?

A. As explained above in the discussion on regulatory risk, the authorized ROE and capital structure will be a primary consideration, as well as:

- Regulatory support for cash flow generation that is consistent with the growth in capital expenditures;
- Continuation of the MYRP; and
- Rates designed to enable financial performance that will produce credit metrics that reinforce current ratings, including improved authorized returns on equity and capital structures that gradually lead to metrics that fully meet rating agency expectations.

IV. THE CAPITAL MARKET AND CREDIT RATINGS ENVIRONMENT AND TRENDS

Q. What is the outlook for the utility industry according to the rating agencies?

A. The broader credit ratings environment for U.S. utilities remains slightly negative amid a backdrop of what S&P calls "slowly deteriorating credit conditions."[29] It has been a negative credit environment for several years. S&P first observed the credit quality of the utility industry deteriorating in 2020, with downgrades exceeding upgrades for the first time in a decade.[30] The downgrade-to-upgrade

[29] S&P Global Ratings, *Global Credit Conditions Q4 2023, Resilience Under Pressure*, at 21 (Sept. 28, 2023), available at Exh. TAS-4C.

[30] S&P, *North American Regulated Utilities' Negative Outlook Could See Modest Improvement*, at 1 (Jan. 20, 2021), available at Exh. TAS-4C.

ratio for utilities stood at an unprecedented 7-to-1 as of the middle of 2021.[31] S&P reverted to a stable outlook for the industry in 2023 after the negative outlook on the industry for the previous three years.[32] Moody's turned negative in its 2023 outlook, citing higher natural gas prices, inflation, and rising interest rates.[33] Like S&P they too returned to a stable outlook this year based on their view that those factors had moderated.[34] They had been concerned for a long time as the threat of rising electric and natural gas costs eroded their confidence in the overall regulatory environment[35] as inflation and rising interest rates captured their attention.[36] Although the formal S&P stance is now stable, it still has a negative tone: "Significant risks for the industry remain, including inflation, record levels of capital spending, and the practice of many companies to operate with minimal financial cushion from their downgrade thresholds."[37]

Q. How can macroeconomic factors threaten utility credit quality?

A. Higher interest rates and inflation are threats because of the unique nature of the utility business model, which combines comprehensive rate regulation with an

[31] S&P, *North American Corporate Credit Midyear Outlook 2021, Industry Top Trends Update, Regulated Utilities*, at 1 (July 15, 2021), available at Exh. TAS-4C.

[32] S&P, *The Outlook for North American Regulated Utilities Turns Stable*, *supra* note 10.

[33] Moody's, Regulated Electric and Gas Utilities-US, *2023 Outlook-Negative on higher natural gas prices, inflation, and rising interest rates* (Nov. 10, 2022), available at Exh. TAS-4C.

[34] Moody's, Regulated Electric and Gas Utilities-US, *Outlook turns stable on low natural gas prices and credit-supportive regulation* (Sept. 7, 2023), available at Exh. TAS-4C.

[35] Moody's, Regulated Electric and Gas Utilities-US, *Persistent elevated electric and gas prices will increase social risks* (Feb. 14, 2022), available at Exh. TAS-4C.

[36] Moody's, Regulated Electric and Gas Utilities-US, *High natural gas prices, inflation and rising interest rates increase social risk*, June 13, 2022; Moody's, Regulated Electric and Gas Utilities-US, *Inflation, high natural gas prices complicate prospects for supportive rate increases*, Nov. 11, 2022

[37] S&P, *The Outlook for North American Regulated Utilities Turns Stable*, *supra* note 10, at 1.

obligation to serve that compels high capital expenditure trends that are difficult to reverse. While either higher interest costs or price levels can harm utility credit quality, together they can be quite harmful to a utility's ratings. Moreover, the industry is confronting these credit headwinds in a financial position that was weakened by earlier trends in leaner cash flow metrics stemming from tax reform[38] and pressure to maintain or increase capital commitments.[39]

Q. Why is inflation particularly harmful to regulated utilities?

A. Regulatory lag. As damaging as regulatory lag is under mildly inflationary economic conditions, inflation at levels above the historical norm can be stressful to utility credit quality. Unregulated firms generally can pass higher costs contemporaneously to consumers as inflation builds. A utility can be faced with a situation where its costs significantly diverge from the levels that rates are based upon, leading to persistent and widening underearning and cash flow problems. If this coincides with a period of high capital spending, the inflationary pressures multiply as spiraling input costs combine with ongoing regulatory lag to outpace the ability of the utility to accurately reflect the costs in rates.

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

[39] S&P, *Industry Top Trends Update*, at 1 (July 18, 2023), available at Exh. TAS-4C.

Q. How else does elevated inflation affect utilities like PSE?

A. Interest rates rise in response to inflation, both from specific actions by the Federal Reserve and market reactions as investors demand more return to compensate for the effect of inflation. As recounted in the Prefiled Direct Testimony of Ann E. Bulkely, Exh. AEB-1T, interest rates have risen by over 100 basis points since the last rate proceeding and could remain elevated until the Federal Reserve is satisfied that inflation is under control and has returned to levels approximating its long-term target rate.[40] Rising debt costs are also emblematic of rising capital costs in general. From a credit quality perspective, it is crucial for PSE to reflect these higher costs in rates so that it can compete with other utilities and corporate issuers in general for capital efficiently to fund its growing capital spending needs.

Q. Why is PSE facing greater capital spending in the coming years, and how does that relate to its ratings?

A. PSE, like many other utilities, must address climate risks. Meeting that challenge will stress its credit profile by exacerbating its overall risk as the balance sheet accommodates the growing investment and other costs of transforming its system. This imperative to decarbonize is driven in part by local factors, such as the state goal to achieve carbon neutrality by 2030, and broader concerns as exemplified in the evolving rating agency focus on environmental, social, governance ("ESG")

[40] Exh. AEB-1T.

risks in the credit analysis of utilities. Rating agencies are increasingly pinpointing ESG risk factors in their analyses.[41] Failure to identify and manage those risks could depress PSE's credit quality and ratings.

Q. What has the evolution in ESG risk assessment meant to utilities and utility ratings?

A. The ESG framework for evaluating risk is, to my mind, a means for organizing the thinking around risks that have always been a part of assessing a utility's risk profile. The rating agencies have raised the importance of these factors by segregating and spotlighting them as investors have become more attuned to the risks. Regulators can facilitate a utility's ability to manage ESG risks by recognizing their importance and factoring the materiality and structure of ESG risks into their deliberations.

Q. If the risks preexisted the ESG phenomenon, why are they demanding greater rating agency attention?

A. The ESG effort doesn't merely repackage the risks. It changes how investors and rating agencies view them and factor them into their analyses. For example, "E" risks have affected utility operations for decades, but the emphasis that ESG brings to environmental issues has accelerated a transformation to an almost exclusively carbon and climate change focus and away from traditional concerns

[41] *See*, *e.g.*, S&P, *How ESG Factors are Shaping North American Investor-Owned Utilities' Credit Quality*, at 7 (Apr. 28, 2021) available at Exh. TAS-4C.

about air and water quality.[42] Another example is "S" risks, which are less susceptible to quantification and have always posed a challenge to analysts. I found it interesting that Moody's employed the ESG framework as it tried to evaluate how the COVID-19 pandemic is a social risk to utilities.[43]

Q. How do the rating agencies view PSE's ESG-related risks?

A. S&P plans to suspend its scoring system to communicate its opinions on ESG risk, but the influence of ESG factors on ratings will remain unchanged. I anticipate that the opinions behind the current scores (E-3 - moderately negative / S-2 - neutral / G-2 - moderately negative)[44] will be carried forward in future ESG analysis without the actual scoring. S&P highlights the negative "E" score, noting that the risk associated with the substantial fossil fuel component of the generation mix is "partially mitigated" (they mean managed) by the efforts to replace it with renewables.[45] That's why I encourage attention to ESG factors by the parties and the WUTC. PSE's ability to continue to manage its environmental risks without burdening its financial risk is the key to accomplishing the transition without damaging its ratings.

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[42] *See*, *e.g.*, Moody's, Sector In-Depth, Regulated electric utilities, US, *Intensifying climate hazards to heighten focus on infrastructure investments* (Jan. 2020), available at Exh. TAS-4C; Moody's, Sector In-Depth, Regulated electric and gas utilities, US, *Grid hardening, regulatory support key to credit quality as climate hazards worsen* (Mar. 2020), available at Exh. TAS-4C.

[43] Moody's, Sector Comment, Electric and Gas Utilities – US, *Supporting customers during coronavirus outbreak to have positive ESG implications* (Apr. 23, 2020), available at Exh. TAS-4C.

[44] S&P, Puget Sound Energy Inc., *supra* note 14, at 7.

[45] *Id*.

Moody's regards PSE's ESG risk profile as "Moderately Negative" driven not just by environmental considerations (consonant with the S&P analysis) but additionally by social risks that compound the negative ESG conclusion.[46] Only governance achieves a neutral score. In their view of how ESG factors affect the PSE ratings, the moderately negative scores "have a limited impact on the current rating with greater potential for future negative impact over time."[47] Social risk, in the Moody's system, is really another way to reference future regulatory risk, which argues for credit-supportive regulatory actions and policies that are governed by the principle of gradualism to avoid threats to customer affordability and the public reputation of PSE.

Q. How are credit agencies considering wildfire risk as a threat to electric utilities?

A. In conjunction with the growing emphasis on tagging ESG risks, Moody's and S&P are increasingly highlighting how climate change appears to be making the event risk of catastrophic wildfire damage more prevalent.[48] PSE in particular has been identified as having "[r]elatively high"[49] wildfire risk in parts of its service territory by S&P and "heightened wildfire risk"[50] in general by Moody's. After being mostly reactive regarding this risk, ratings downgrades are beginning to

[46] Moody's, *Credit Opinion*, *supra* note 12, at 7.
[47] *Id*.
[48] *See*, *e.g.*, S&P, *A Storm Is Brewing: Extreme Weather Events Pressure North American Utility Credit Quality* (Nov. 9, 2023) available at Exh. TAS-4C.
[49] *Id*. at 2.
[50] Moody's, *Credit Opinion*, supra note 12, at 6.

materialize as attention to the issue has grown. Moody's recently downgraded PacifiCorp and noted that "wildfire risk, a form of physical climate risk, was a key driver of the downgrade."[51] This heightened scrutiny points to the importance of many of the themes of my testimony: the greater influence of ESG factors in utility credit analysis, acknowledgment by the WUTC of the expanding risk faced by PSE specifically, and the necessity to support PSE's ability to manage its financial position with more than a minimal or even negative credit metric cushion to protect ratepayers from the consequences of unexpected downgrades.

V. CONCLUSIONS

Q. Please summarize your recommendations.

A. To solidify PSE's credit quality and maintain a sufficient cushion in the ratings in anticipation of the upcoming stress on its financial condition as it embarks on major energy transition and wildfire investments, I recommend the approval of the proposed MYRP, including the various new recovery mechanisms for important new initiatives, the requested CWIP treatment, and a phased-in authorized ROE and capital structure that support the credit-metric expectations of the rating agencies. Ratings stability in the face of extraordinary stresses on the credit profile of PSE is crucial to ratepayers as PSE pursues environmental goals to achieve prioritized public policies while working to reduce expanding wildfire

[51] Moody's, *Moody's downgrades PacifiCorp to Baa1, outlook stable*, at 1 (Nov. 21, 2023) available at Exh. TAS-4C.

risks. The positive momentum created by the previous rate decision for PSE should be perpetuated in this case so that ratepayers continue to realize the benefits of strong and durable financial integrity for its utility.

Q. Does this conclude your prefiled direct testimony?

A. Yes.