

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-12_____

DOCKET NO. UG-12_____

DIRECT TESTIMONY OF

KAREN S. FELTES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

2 **Q. Please state your name, employer and business address.**

3 A. My name is Karen S. Feltes. I am employed as the Senior Vice President of
4 Human Resources and Corporate Secretary for Avista Corporation, at 1411 East Mission
5 Avenue, Spokane, Washington.

6 **Q. Would you briefly describe your educational background and**
7 **professional experience?**

8 A. Yes. I graduated from the University of Washington with a Bachelor of Arts
9 Degree in Communications with concentrations in Public Relations and Journalism. I went
10 on to receive my M.B.A. from Seattle City University. I have worked in the field of human
11 resources for over 30 years. Prior to joining the Company in 1998, I held various senior
12 level HR management positions in both public and private industry, including King County
13 and Microsoft. I have attended formal training programs presented by the World at Work
14 Association in executive and international compensation and have received my certification
15 as a Compensation Professional. I am currently a member of the World at Work, formerly
16 the American Compensation Association, as well as a member of the Society for Human
17 Resource Management. In 2001, I was appointed Vice President of Human Resources for
18 Avista Corporation and in 2006 I became Senior Vice President of Human Resources.

19 **Q. How is your testimony organized?**

20 A. In my testimony I will start with an overview of Avista's overall
21 compensation philosophy. I will provide an overview of the benefit plans offered by the
22 Company, including a discussion around increasing costs related to the Company's defined
23 benefit retirement plan and post-retirement medical costs. Next I will provide an overview

1 of the employee Incentive Plan. Finally, in accordance with Order No. 06 in Dockets UE-
2 110876 and UG-110877, I will provide a summary and explanation of the appropriateness of
3 amounts of executive compensation included in retail rates.

4 **Q. Are you sponsoring exhibits in this proceeding?**

5 A. Yes. I am sponsoring Exhibit Nos. ____ (KSF-2) and ____ (KSF-2C),
6 ____ (KSF-3), ____ (KSF-4), ____ (KSF-5C), and ____ (KSF-6C). Exhibit Nos. ____ (KSF-2)
7 and ____ (KSF-2C) consist of a copy of the report titled “Review of Executive Officer
8 Compensation” filed with the Commission on February 28, 2012. Exhibit No. ____ (KSF-3) is
9 the Salary Increase Budget Comparison 2011/2012. Exhibit No. ____ (KSF-4C) is the
10 Historical Lineman Wage Comparison. Exhibit No. ____ (KSF-5) is a copy of the Employee
11 Incentive Plan. Finally, Exhibit No. ____ (KSF-6C) is an updated version of Attachment F
12 which was included in the “Review of Executive Officer Compensation” report included
13 with Exhibit No. ____ (KSF-2C).

14

15 **II. TOTAL COMPENSATION OVERVIEW**

16 **Q. Please provide an overview of Avista’s total compensation philosophy.**

17 A. Avista is committed to providing a total compensation program that will
18 attract and retain qualified people required to meet the needs and expectations of all utility
19 stakeholders, including, but not limited to, customers, shareholders and regulators. The
20 overarching compensation philosophy is that success is measured by the ability to hire,
21 develop, and retain the most competent people to work in a very complex industry. In an
22 effort to recruit and retain such people, Avista provides base salaries, performance-based
23 award programs and benefits that are competitive in the marketplace, as benchmarked

1 against other similar-sized companies in regional and national markets. Avista's total
2 compensation program is designed to, among other things:

- 3 • Clearly identify the specific measures of Company performance that are likely
4 to create long-term value for the Company's customers and shareholders;
5
- 6 • Structure incentive pay programs to reward specified levels of performance on
7 measures designed to help the Company achieve:
 - 8 • Shareholder value targets;
 - 9 • Earnings per share targets;
 - 10 • Relative stock performance levels compared to peers;
 - 11 • Customer service targets;
 - 12 • Operational targets;
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- 14 • Promote a culture of safety;
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- 16 • Align elements of the incentive plans among all Company employees and
17 executive officers;
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- 19 • Pay competitively compared to other employers within our market;
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- 21 • Provide a range of payout opportunities based on the level of achievement of
22 performance goals; and
23
- 24 • Reward outstanding performance.
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26 Avista's total compensation philosophy creates focus for all employees because a
27 portion of the overall earning opportunity is at risk. Employees and executive officers, as a
28 whole, have to achieve the goals of the incentive plan for the plan to payout. This tension in
29 plan design helps motivate and focus all employees on the stated goals of the Company. In
30 order to achieve additional level of compensation, employees have to keep focused on cost
31 control, customer satisfaction and reliability within the system. Avista's existing total
32 compensation plan is designed to retain current employees, while remaining competitive
33 enough to attract new employees. A pay-at-risk component of compensation is not designed
34 to pay out the full incentive opportunity every year, nor is it designed to have no payout for
35 an extended period of time. Pay-at-risk plans are designed to help focus employees on

1 making decisions that benefit the Company and its customers, while at the same time
2 functioning as an integrated component of total compensation.

3 **Q. Please explain how executive compensation is set.**

4 A. The Compensation Committee of the Board of Directors, made up entirely of
5 directors who are independent of management, is responsible for considering and approving
6 the compensation and benefits for executive officers of the Company. The Compensation
7 Committee believes that an effective total compensation plan should be structured to focus
8 executive officers on the achievement of specific business goals set by the Company and to
9 reward executive officers for achieving those goals. Considerable time is spent weighing
10 various design options to ensure that top management's compensation is primarily
11 performance-based, fair, and reasonable and does not encourage key decision makers to take
12 excessive risks.

13 To assist them in their review of current executive officer pay practices and, as
14 appropriate, provide recommendations on current market practices, the Compensation
15 Committee employs an independent executive compensation consultant, Towers Watson, a
16 nationally recognized consulting firm. Towers Watson assists in the following ways:

- 17 • Benchmarking pay practices among the peer group and providing a broader market
18 perspective;
- 19 • Assessing the design of individual pay elements and the total pay program relative
20 to the Company's objectives, market practices and other factors;
- 21 • Assisting the Compensation Committee in reviewing compensation
22 recommendations prepared by management; and
- 23 • Providing the Compensation Committee with an outside perspective and, as
24 appropriate, specific recommendations on program design.

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29 The Compensation Committee annually compares each element of total direct

1 compensation, which includes base salary, annual cash incentives, and the value of long-
2 term incentive grants, against a specific peer group of publicly-traded companies within the
3 energy/utility industry. The companies in the peer group generally recruit individuals who
4 are similar in skills and background to those the Company recruits to fill senior management
5 positions, and are the companies with which Avista competes for executive officers and for
6 shareholder investment.

7 In addition, as required by the Exchange Act, Proposal 4 “Advisory Vote On Executive
8 Compensation” was included in the 2011 Proxy. This “Say-On-Pay” proposal is a non-
9 binding advisory vote, on the Company’s executive compensation. It passed with a 94%
10 shareholder approval, indicating that shareholders believe the executive compensation
11 program is designed appropriately. For additional information on setting of executive
12 compensation, please see Exhibit Nos.__(KSF-2) and __(KSF-2C) Review of Executive
13 Compensation, as discussed below.

14 **Q. What level of officer compensation is included in the Company’s filing?**

15 A. As discussed by Company witness, Ms. Andrews, the salary in the
16 Company’s filing is the actual 2011 base salary paid in the 2011 historical test year. No
17 2012 increases in officer salaries have been included in this filing. A pro-forma adjustment,
18 however, has been included to reflect the most current utility/non-utility officer allocations,
19 resulting in a slight reduction in expense. The executive officer incentives included in the
20 Company’s filing is approximately \$575,000 (system) based on a six year average (2006-
21 2011) of the executive officer Short Term Incentive Plan (STIP) described later in my
22 testimony. Overall, Washington’s portion of the total salaries and incentive pay for all
23 executive officers that is currently included in rates (as shown in Exhibit Nos. ____ (KSF-2)

1 and ____ (KSF-2C)), is \$2.4 million, or 25% of the total executive officers' salaries and
2 incentive pay.¹

3 **Q. Please explain how employee compensation is set.**

4 A. In setting employee compensation, competitive market data is monitored on
5 an on-going basis to ensure the total program is competitive with other companies in the
6 industry, and at the same time is cost-effective. The Company assesses the competitiveness
7 of the program by looking at comparable value indices developed by Towers Watson.

8 Avista also participates in numerous confidential salary surveys provided by third-
9 party consulting firms which compare Avista's pay programs to other organizations in the
10 utility industry labor markets, as well as other industries, regionally and nationally. Salary
11 surveys are used for projecting salary increase estimates and salary range changes, as well as
12 benchmarking jobs to market data. Avista benchmarks many jobs within the Company and
13 reviews market data to determine if the salary range midpoints still accommodate the new
14 estimated market values established by the benchmarking process. Based on information
15 provided in these surveys, salary recommendations are presented to the independent
16 Compensation Committee of the Board of Directors for approval. The Compensation
17 Committee can choose to grant higher or lower salary adjustments if updated market data
18 warrants a change.

19 In May, 2011, the Compensation Committee agreed to set a minimum salary increase
20 for non-union employees of 2.5% for 2012, based on the survey data received. In November
21 2011, this amount was reset to 3.0% which was at or near the average projection for the

¹ Approximately 42% of the total executive officer salaries and incentives are included in retail rates for customers in Washington, Idaho and Oregon. Approximately 25% of the total is included in Washington retail rates. The remaining salaries and incentives (or 58%) are not charged to customers through retail rates.

1 utility industry as well as other industries, regionally and nationally. Please see Exhibit
2 No.__(KSF-3C) for additional information. Through preliminary survey data received from
3 outside consulting firms, Avista expects a minimum salary increase for 2013 of 2.5% for
4 non-union employees. This increase will be presented to the Compensation Committee in
5 May, 2012 for approval. (If not approved, Avista will adjust its revenue requirement
6 accordingly.)

7 Union wage increases are governed by contract between the Company and the union.
8 The current union contract expires March 25, 2014. As explained by Company witness,
9 Ms. Andrews, the 2012 and 2013 non-union wage increases of 3.0% and 2.5% respectively,
10 as well as the 3.0% contracted for union increases in 2012 and 2013 have been included in
11 the Company's filing.

12 Confidential Exhibit No.__(KSF-4C) shows the lineman wages in the Northwest
13 over time. This confidential document shows that union contract wages are in line with the
14 Utility Industry average.

15 **Q. How has the economic downturn impacted Avista's compensation**
16 **program as it competes for qualified employees?**

17 A. Avista carefully explored various options surrounding compensation and
18 benefit programs to assess whether eliminating or reducing various programs would be
19 appropriate given the economic downturn regionally and nationally. We concluded that
20 freezing salaries or eliminating programs such as the incentive plan would have unintended
21 consequences. For example, we participate in annual benchmark surveys as discussed
22 earlier. We compete for engineers, technical professionals such as system operators, as well
23 as individuals in finance that have utility experience. If we were to freeze salaries or

1 eliminate incentives, it is clear to us that within one to two years after freezing wages,
2 Avista would have to make market adjustments to bring current employee salaries up to
3 market levels. Therefore, we have taken a measured approach to the salary adjustment that
4 allows us to provide lower salary increases, yet keep pace with the market until such time
5 that the economy returns to a more normal place.

6 Avista recognizes that the economic downturn has led to increased unemployment
7 and caused some companies to freeze all salaries or provide no or provide lower increases to
8 its employees. However, the utility industry continues to face labor and managerial
9 shortages that challenge our ability to lead key business functions and staff significant
10 infrastructure projects. In order to fill needed skill sets and remain competitive in hiring,
11 most utilities, including Avista, have not made significant changes to their compensation
12 programs or instituted overall salary freezes.

13 A large component of Avista's employees consists of highly-skilled technical
14 individuals such as engineers, accountants, information technology, etc. While the overall
15 unemployment remains high, at the end of 2010, 78% of Americans who were unemployed
16 had no post-secondary education, while the unemployment rate for those with college
17 educations or graduate degrees was 4.8%.² Couple that with twice as many college
18 graduates obtaining degrees in social sciences and business, than in science, technology,
19 engineering and mathematics, and the shortage of qualified candidates becomes even higher.
20 Further, Americans are no longer as likely to relocate for a new job as they once were. In
21 the 1950's and 1960's, one in five Americans changed residences every year, but that rate

² McKinsey Global Institute, "An Economy that Works: Job Creation and America's Future, June 2011, p. 9,5,16.

1 has fallen by half to one in ten today. There are many reasons for lower mobility, but an
2 important factor is the rise in home ownership; renters are three times as likely to move
3 within a year as home owners, and the collapse of the real estate market undoubtedly makes
4 it harder for many home owners to consider relocation. As a result of these various factors,
5 Avista is faced with a more limited pool of applicants with a proven skill set in the fields
6 needed to successfully meet the needs of a utility.

7 As a vertically integrated, publicly-owned utility, Avista operates in a very complex
8 environment. Not only does Avista own and operate an electric distribution system, but also
9 owns and operates extensive generation and transmission facilities, all of which are used to
10 service customers in multiple service areas. Avista must manage and optimize its generation
11 assets daily, keeping existing assets operational and licensed for our customers and develop
12 future resource needs. In order to attract the highly-skilled individuals needed to satisfy all
13 of the demands of our complex business, Avista must offer a comprehensive compensation
14 program, which includes incentives and benefits to recruit and retain these valuable
15 employees.

16 If we were to freeze salaries internally, we most likely would have to pay new
17 employees the going market level and this would create compression for existing employees.
18 This creates dissatisfaction and can cause current employees to seek employment elsewhere.
19 Retention is critical in a utility where often projects take years to complete. Consistency,
20 depth and breadth of knowledge, including knowledge of state and federal regulations, are
21 instrumental to successful project implementation and keeping costs as low as possible for
22 our customers. This is especially important given the complex demands of the regulatory
23 environment.

1 **Q. Industry-wide, is there a looming shortage of skilled employees?**

2 A. Yes, as of February 2012, the average unemployment for the overall Utility
3 Sector in the State of Washington is 5.3% compared to the overall state average of 8.3%³. In
4 recent statements by the Federal Reserve Chairman, Ben Bernanke, the Federal Reserve
5 considers full employment to be between 5.2% and 6.0%⁴. The McKinsey Institute states
6 full employment is estimated to be 5%⁵. A very specific skill set is needed for some of our
7 more technical positions such as Distribution Dispatch, System Operations, and Line
8 Personnel. One job posting can result in a very high number of applications, but with only
9 5-10% qualified for the position. Because of the technical nature for some of our positions,
10 and the in-depth knowledge required of our systems, often we can only promote from
11 within, further reducing the pool of eligible candidates. According to a recent report by the
12 U.S. Power and Energy Engineering Workforce Collaborative⁶:

13 “About 45% of the engineers currently employed by the Nation’s electric
14 and natural gas utilities will be eligible for retirement over the next five
15 years, creating a need for more than 7,000 engineers industry wide. At the
16 same time, there is a significant decline in the number of students who are
17 choosing to study engineering and related disciplines. As a result, the
18 nation’s utilities are facing what could become a crisis situation unless this
19 trend is reversed.” [Quoting, “National Grid takes action to address
20 impeding shortage of utility engineers”, RP Newswires]
21

22 This limited pool of skilled employees necessitates a comprehensive compensation
23 package in order to recruit and retain employees.
24

³U. S. Bureau of Labor Statistics, Workforce Statistics, Utilities Sector, February, 2012.

⁴ Bloomberg, “Bernanke Seen Accepting Faster Inflation as Fed Seeks Jobs Boost” 03/06/12

⁵ McKinsey Global Institute, “An Economy that Works: Job Creation and America’s Future,” June 2011, p. 21.

⁶ “Preparing the U.S. Foundation for Future Electric Energy Systems: A Strong Power and Energy Engineering Workforce,” prepared by the Management Steering Committee of the U.S. Power Energy Engineering Workforce Collaborative, April 2009, p. 4.

1 **Q. Has Avista taken any steps in the community to help develop programs**
2 **specific to the utility industry?**

3 A. Yes, as discussed above, there is a shortage of new graduates with the
4 specific technical degrees needed for our industry. Avista has been working closely with
5 area universities in the development of a curriculum for areas of study specific to the utility
6 industry. Gonzaga University offers a certificate and Master's Degree in Transmission and
7 Distribution Management, which was promoted by the Company. The Company also has
8 been instrumental in the development of the "Energy Systems Innovation Center" at
9 Washington State University. Through this unique interdisciplinary approach, WSU is
10 addressing the social, economic, and policy challenges of modernizing the electric power
11 grid and helping to facilitate the integration of renewable energy resources. The Energy
12 Systems Innovation Center at WSU will play a leading role in research and technology
13 innovations for the smart grid and other critical areas in energy systems that are essential
14 for economic development in the state of Washington and beyond. For additional
15 information regarding the Smart Grid, please see the testimony of Company witness, Mr.
16 Kopczynski.

17 Avista is participating in a pilot program, Troops to Energy Jobs – through the
18 Center for Energy Workforce Development (CEWD). The Troops to Energy Jobs initiative
19 is an effort by five investor-owned utilities to develop an accelerated process for bringing
20 military veterans into the energy industry workforce nationwide. The CEWD was formed in
21 2006 to help utilities work together to develop solutions to the workforce shortage in the
22 utility industry. An area we are putting special emphasis on is our apprentice positions in the
23 lineman side and the Company's other apprentice positions. We were successful in getting

1 three veterans enrolled in our January Line School classes. The Line School is a main feeder
2 pool for our apprenticeships and an entry into energy careers.

3 **Q. What steps has the Company taken to educate, train and develop**
4 **employees?**

5 A. Avista has developed programs to aid in the development of its employees in
6 various areas of the Company. For example:

- 7 • Aspiring Leadership Program
- 8 • Avista Safety and Craft Training
- 9 • Coaching/Mentoring
- 10 • Job Shadowing or Rotation
- 11 • Local Training Opportunities/Lectures/Seminars/Conferences
- 12 • Project Management Courses

13 Specialized training in functional areas such as safety, accounting, etc. is supported and
14 encouraged. Many of our employees attend annual training sponsored by the Electric
15 Energy Institute and the American Gas Association. Those employees that are certified,
16 such as CPA's, PE's, etc., are required to complete continuing education every year. This
17 keeps our employees up to date on emerging issues and requirements for each respective
18 field.

19 **III. EMPLOYEE BENEFITS**

20 **Q. Please describe the Company's employee benefit plans.**

21 A. The Company offers a comprehensive benefit plan for employees to meet,
22 among other things, medical and retirement needs at competitive levels. All regular
23 employees are eligible for the Company's defined benefit pension plan, defined contribution

1 401(k) plan, medical, dental and vision coverage, company-paid term life insurance,
2 disability insurance, paid time off and paid holidays. Employees have several choices to
3 elect benefits, such as medical and life insurance, so that they can determine the best fit for
4 their circumstances. These plans are designed to be competitive with the overall market
5 practices and are in place to attract and retain the talent needed in the business.

6 Retirement programs are crucial to attracting and retaining a skilled workforce
7 within the utility industry. For active employees, a pension plan and 401(k) plan provide a
8 balanced retirement opportunity for employees. The Company's pension plan provides a
9 retirement benefit based upon employees' compensation and years of credited service. The
10 401(k) Plan provides Roth after-tax and/or tax deferred savings as well as the opportunity
11 for matching dollars.

12 The Company sponsors a self-funded medical benefit plan that provides various
13 levels of coverage for medical, dental and vision. The Company offers wellness programs
14 that encourage employees to take responsibility for their health care decisions and make
15 lifestyle changes to avoid health care issues in the short term and into retirement.

16 These programs, in combination with pay and other benefits, are keys to attracting
17 and retaining quality employees to run our business.

18 **Q. What are the factors that drive the design of the benefits program**
19 **offered to employees?**

20 A. The Company's benefit programs are designed to be cost-effective,
21 competitive with other organizations in the utility industry, and attract and retain qualified
22 employees. Competitive market data is monitored on an on-going basis to ensure the total

1 benefit program is competitive with other companies in the industry, and at the same time is
2 cost effective.

3 The Company assesses the competitiveness of the benefits program by looking at
4 comparable value indices developed by Towers Watson, and benchmarking data from
5 Mercer⁷. Both are nationally recognized consulting firms. Also, comparable benefit data
6 reviews are performed periodically with other regional utilities.

7 Approximately half of our employee population is unionized. The bargaining
8 process and contract requirements are considered when designing or changing benefits.

9 **Q. What is the reason for the increase in pension costs from 2011 to 2012?**

10 A. The Company's pension expense portion of this adjustment is determined in
11 accordance with Accounting Standard Codification 715 (ASC-715), and has increased on a
12 system basis from approximately \$21.9 million for the actual test year costs for the twelve
13 months ended December 31, 2011, to \$27.0 million for 2012. The increase in pension cost is
14 primarily due to a decrease in the discount rate used in calculating the pension expense and
15 liability as well as a decrease in the expected return on assets and changes in other actuarial
16 assumptions. The discount rate used to calculate the pension cost decreased from 6.3% in
17 2010 to 5.05% in 2012. The discount rate is derived by identifying theoretical settlement
18 portfolio of high quality corporate bonds sufficient to provide for a pension plan's projected
19 benefit payments in accordance with accounting standards. The high quality corporate bonds
20 are selected from the AA or Aa bond universe (as rated by S&P and Moody's respectively).

21 **Q. Has the Company implemented specific cost measures to reduce the**
22 **pension expense?**

⁷ Mercer is a nationally recognized expert in HR and financial services, products and services with over 19,000 employees serving clients in more than 180 cities and 40 countries and territories world-wide.

1 A. Yes. To reduce the pension expense into the future, the Company reduced the
2 defined benefit pension formula for all non-union new hires effective January 1, 2006, and
3 union new hires, effective January 1, 2011. Contrasting the old formula to the new formula,
4 the present value of future benefits for new entrants represents a decrease of 23% in costs.
5 The Benefits Plan Administration Committee constantly seeks opportunities for benefit
6 program changes that will reduce costs.

7 **Q. What is causing the increase in post-retirement expense included in this**
8 **case?**

9 A. Medical insurance and post-retirement expense has increased on a system
10 basis from \$25.26 million for the actual test year for the twelve months ended December 31,
11 2011, to \$30.59 million for 2012. Accounting Standard Codification 715 (ASC-715)
12 requires employers to recognize the cost of providing post retirement benefits on an accrual
13 basis. The cost must be recognized during the working years of the employees to full
14 eligibility date. Most of the increase in ASC-715 expense can be explained by declining
15 interest rates, lower than expected investment returns, and greater amortization expense due
16 to changes in the valuation of the actuarial liability.

17 The medical trend is a key assumption used to determine the expense as well as the
18 projected liability to provide this benefit. The medical trend represents the rate at which the
19 cost of medical claims is expected to increase in the future. A medical trend rate is applied
20 to retiree claims experience to determine a long-term expectation of increase in medical
21 costs.

22 **Q. What actions are the Company taking to mitigate the post-retirement**
23 **expense increase?**

1 A. The Company has continued to increase the portion of the premium that the
2 retiree is paying. As a result, retirees are now paying a significant portion of the premiums
3 on health insurance. A few years ago, retirees under 65 were only paying 10% of the
4 composite health insurance premiums and now they pay over 50%. Additionally, the self-
5 insured medical plan participates in the Medicare Part D subsidy. This subsidy reduces the
6 plan cost for the prescription drug benefits for the Medicare-eligible retirees.

7 In 1997, the Company implemented a plan to phase out company-provided retiree
8 life insurance. As a result, the Company maintains the life insurance for current retirees and
9 for employees hired prior to July 1997. New hires after this date do not have company
10 provided retiree life insurance coverage.

11 **Q. Why does the Company continue to maintain and support post-**
12 **retirement benefits?**

13 A. The Company continues to support a retiree medical program in order to
14 remain competitive in total compensation within our industry. According to Mercer's 2011
15 National Survey of Employer-Sponsored Health Plans, 69% of utilities, with 500 or more
16 employees, offer retiree medical coverage to pre-Medicare eligible retirees and 58% offer it
17 to Medicare-eligible retirees.

18 **Q. How is Avista addressing the rising cost of health care?**

19 A. Based upon overall plan utilization, the self-insured medical plan experienced
20 no increase to the composite rate for 2012. This follows a 2.6% increase to the composite
21 rate for 2011. The self-insured medical plan is open to eligible active employees as well as
22 pre-Medicare retirees and Medicare-eligible retirees. Even though the plan is not
23 experiencing increased rates in 2012, the Company continues to encourage employees to

1 participate in wellness programs, such as annual biometric screenings, health risk
2 assessments and other health initiatives aimed at improving quality of life.

3 The Company also has stop-loss insurance coverage to mitigate the impact of
4 medical risk. The policy provides stability for the Company, in the event of unusually high
5 individual claims as well as in the aggregate. The coverage is reviewed annually, and
6 adjustments are made as needed. The Company has also made changes to co-pays and out-
7 of-pocket minimums to help reduce costs to the Company. Effective January 1, 2011, union
8 employee co-pays are now in line with non-union employees, shifting a higher amount of
9 premium to the employees, thereby reducing the amount paid by the Company.

10 **Q. What is the Company's approach to health care reform?**

11 A. The Company continues to monitor and keep abreast of regulatory
12 developments in health care reform and the impact it will have on medical coverage for both
13 active and retired employees. We also intend to move forward with actionable items, such
14 as providing employees with tools/resources to manage their health, balance financial
15 incentives with other strategies to encourage healthy behaviors, and evaluate retiree medical
16 design.

17 **Q. Are there additional benefits provided to executive officers?**

18 A. In order to attract and retain executive officers and stay competitive within
19 our peer group of companies, additional benefits are offered to executive officers over and
20 above those provided to employees. These benefits are as follows:

21 1. Supplemental Executive Officer Retirement Plan (SERP):
22 In addition to the Company's retirement plan for all employees, the Company
23 provides additional pension benefits through the SERP to executive officers of the
24 Company who have attained the age of 55 and a minimum of 15 years of credited
25 service with the Company. The costs associated with SERP are excluded from retail
26 rates.

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2. Deferred Compensation:

The Executive Officer Deferred Compensation plan provides the opportunity to defer up to 75% of base salary and up to 100% of cash bonuses for payment at a future date. This plan is competitive in the market, and provides eligible employees and executive officers with a tax-efficient savings method. The costs associated with Deferred Compensation are excluded from retail rates.

3. Perquisites:

Because the total compensation program for executive officers is fair and market competitive, the Company does not provide any additional benefits in the form of perquisites to the CEO or any other officer.

Please see Exhibit No. ____ (KSF-2), Attachment E, which is the 2011 Employee

Benefit Summary, for more information.

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IV. INCENTIVE PLAN

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Q. Please explain the overall philosophy behind Avista's Executive Officer Incentive Plan.

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A. The Executive Officer Short Term Incentive Plan (STIP) is designed to align the interests of senior management with both shareholder and customer interests in order to achieve overall positive financial performance for the Company. The STIP is a pay-at-risk plan whereby employees are eligible to receive cash incentive pay if the stated targets are achieved.

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The STIP has five operational components, plus two earnings-per-share (EPS) components. The total amount associated with utility operational components is 40% and is broken down as follows: 20% O&M Cost-Per-Customer, 5% Customer Satisfaction, 5% Reliability, 5% Response Time and 5% Performance Excellence. The earnings-per-share components account for 60% of the total opportunity and are broken out into 50% utility earnings-per-share and 10% non-utility earnings-per-share. Only the operational

1 components (40%) are proposed to be included in retail rates, because they reflect measures
2 that are designed to drive cost-control, and delivery of safe, reliable service with a high level
3 of customer satisfaction. The remaining 60% is borne by shareholders.

4 **Operations Components**

5 The utility operational goal components in the 2011 Executive Officer Short Term Incentive
6 Plan were as follows:

7 1. **O & M Cost-Per-Customer (20% of STIP):**

8 This measure provides an incentive to keep actual O&M costs as low as possible.
9 The 2011 STIP placed emphasis on aggregate utility cost-per-customer to encourage
10 company-wide teamwork and consistent results in order to keep costs reasonable.
11 The O&M cost-per-customer target is based on the projected number of customers,
12 targeted O&M expense and a savings mechanism between employees and the
13 Company. There is no payment under this portion of the plan if the minimum
14 performance level is not achieved.

15
16 2. **Customer Satisfaction (5% of STIP):**

17 The customer satisfaction rating measures overall customer satisfaction with the
18 service a customer received during a recent contact with the Company. The rating is
19 derived from a “Voice of the Customer Survey”, which is conducted each quarter by
20 an independent agency. The measure is widely used in the industry for external
21 reporting. The Company uses a combination of the “satisfied” and “very satisfied”
22 ratings, rather than use the standard “satisfied” rating, which is typically used in the
23 industry. By combining these two measures, it actually makes the target more
24 difficult to achieve. This element of the plan is set as a “meets” or “not meets” target.
25 There is no payment under this portion of the plan if the target is not achieved.

26
27 3. **Reliability Measure (5% of STIP):**

28 Providing reliable service levels for our customers is also important. This target in
29 the STIP is a measure that tracks how quickly the Company restores outages, how
30 frequently customers are affected by outages and what percent of customers are
31 experiencing more than three sustained outages per year. We combined three
32 common industry indices in order to balance our focus of electric reliability. The
33 Company tracks the average restoration time for sustained outages that affect our
34 customers (CAIDI) and the average number of sustained outages per customer
35 (SAIFI). The third metric is fairly new to the utility industry and measures the
36 percentage of customers that experience more than three sustained outages in the
37 year (CEMI³). We chose this level of outages over others because industry data
38 received from JD Power’s customer service surveys indicate that customers are more
39 apt to be dissatisfied after three outages. Each metric has a set target to achieve and
40 then are weighted equally (one-third of 100%) and combined into one index.

1 Focusing on these measurements enables the Company to direct our resources
 2 appropriately and efficiently in order to contain costs and plan for future
 3 infrastructure upgrades that will benefit the customer. There is no payment under this
 4 portion of the plan if the target is not achieved.

5
 6 4. Response Time (5% of STIP):

7 This metric measures the percentage of time the Company responds within targeted
 8 time goals for dispatched natural gas emergency calls. The Company tracks the time
 9 between the receipt of the call to the time our crew or serviceman arrives on-site,
 10 assesses the situation and reports back to dispatch. The Company tracks two types of
 11 emergency calls: priority 1 (blowing gas, explosions and/or fires, etc) and priority 2
 12 (inside or outside odors, runaway furnaces, etc). The primary objective is customer
 13 and public safety while consistently treating customers the same throughout our
 14 service territory. There is no payment under this portion of the plan if the target is
 15 not achieved.

16
 17 5. Performance Excellence (5% of STIP):

18 This metric combined two separate measures into one. By the end of 2011, the
 19 objective was to implement or complete 92 project milestones and, through process
 20 improvements achieve \$6.2 million in value to redeploy elsewhere where needed.
 21 The metric demonstrates the Company's commitment to continuously look for
 22 opportunities for efficiencies in order to keep costs reasonable for our customers in
 23 the long term. There is no payment under this portion of the plan if the target is not
 24 achieved.

25
 26 The utility operational component metrics and allocations have varied over time as have
 27 payouts associated with such components borne by customers and included in rates (which
 28 will be addressed later).

29 **Earnings-Per-Share Components**

30 The Utility and Non-Utility EPS components of the STIP are summarized below:

31 1. Utility Earnings Per Share (EPS) (50%):

32 This award will depend on attaining EPS goals for the utility operations. The
 33 actual amount paid, related to the utility EPS target, could increase (up to 150%
 34 of the utility EPS target award) or decrease (as low as 0% of the utility EPS
 35 target award) depending on the Company's actual performance.

36
 37 2. Non-Utility Earnings Per Share (EPS) (10%):

38 This award will depend on attaining EPS goals for non-utility operations. The
 39 actual amount paid, related to the non-utility EPS target, could increase (up to

1 150% of non-utility EPS target award) or decrease (as low as 0% of the non-
2 utility EPS target award) depending on the Company's actual performance.
3

4 The earnings-per-share components of the STIP discussed in items 1 and 2 above are borne
5 100% by shareholders. As with all components of executive officer compensation, the
6 Short Term Incentive Plan is reviewed annually by the Compensation Committee and
7 modifications are made as necessary. As discussed by Ms. Andrews, the amount of the
8 incentive plan expenses included for all executive officers in the filing is approximately
9 \$355,000 (Washington only), based on a six year average (2006-2011). For additional
10 information on the Executive STIP and the level included in rates, please see Exhibit
11 No. __ (KSF-2),

12 **Q. Please explain the overall philosophy behind Avista's Employee**
13 **Incentive Plan.**

14 A. In accordance with the Company's overall compensation design to align
15 elements of incentive plans among all Company employees and executives, the Employee
16 Incentive Plan (Plan) has essentially the same stated goals as the STIP discussed above.
17 Both plans help motivate and focus employees on stated goals while recognizing and
18 rewarding employees for their contributions toward achieving those goals. The Plan is
19 essentially the same as the STIP, with two exceptions:

- 20 • The EPS discussed above are not included in the employee incentive plan.
21
22 • The operations component contributions are weighted differently.

23 The weightings for utility operations are as follows: 75% O & M Cost-Per-Customer,
24 10% Customer Satisfaction, 5% Reliability Index, 5% Response Time, and 5% Performance
25 Excellence. Annually, the Company will assess the employee incentive plan to determine if

1 modifications should be made to keep the employees focused on the core business strategies
2 of the Company. During a special Compensation Committee meeting on March 8, 2012, the
3 Plan was reviewed and approved. Currently, the 2012 O&M Cost-Per-Customer targets are
4 under review and will be finalized by March 30, 2012. The amount of the incentive plan for
5 non-officer employees included in the Company's filing is approximately \$2.7 million
6 (Washington only), based on a six year average (2006-2011). Please see Ms. Andrews
7 testimony for additional information and Exhibit No. ____ (KSF-5) for the 2011 Employee
8 Incentive Plan.

9 **Q. Did Avista achieve cost-savings in 2011 as compared to planned expenses**
10 **for the year?**

11 A. Yes. The Company saved approximately \$3.0 million of O&M costs during
12 the 2011 test period, when comparing actual expenses to those planned for the year. A
13 portion of those savings would have been paid out to employees as part of the incentive
14 plan, but the balance of the savings (approximately \$2.0 million) remain in the 2011 test
15 year as a reduction in costs, for the benefit of customers. Ms. Andrews provides additional
16 details surrounding the expenses included in the test period and the accounting treatment
17 included in this case.

18 **Q. In general terms, how is the pay-at-risk component incorporated into a**
19 **total compensation package for employees?**

20 A. Avista is committed to providing a total compensation program that provides
21 base salaries, performance-based award programs and benefits that are competitive in the
22 marketplace. Market data shows that pay-at-risk or variable pay plans are prevalent in over

1 80% of organizations, and most utilities, including Avista, have some kind of pay-at-risk
2 plan.

3 A compensation program without pay-at-risk would drive base wages upward, which
4 in turn, would increase pension liability costs as well. Having a pay-at-risk component is
5 another way the Company is working to not embed year-over-year costs, and helps to
6 maintain reasonable rates for our customers. The Company's current plan involves a
7 meaningful amount of pay-at-risk for all employees. Therefore, the most direct benefit to
8 customers from the structure of the Incentive Plan is that total compensation is dependent on
9 employees achieving specific objectives that have a direct tie to customer satisfaction and
10 cost efficiency.

11 A pay-at-risk component of compensation is not designed to pay out the full
12 incentive opportunity every year, nor is it designed to have no payout for an extended period
13 of time. Pay-at-risk plans are designed to help focus employees on making decisions that
14 benefit the Company and its customers, while at the same time functioning as an integrated
15 component of total compensation. As I noted earlier, most utilities have some form of pay-
16 at-risk component in their total compensation program.

17 **Q. Please review the evolution of the Company's incentive plan.**

18 A. In the Company's Order No. 7, dated November 19, 2010, in Docket Nos.
19 UE-100467 and UG-100468, the Company was ordered to review its non-executive
20 incentive plan, by identifying, explaining and to the extent possible, quantifying the
21 program's benefits to ratepayers as well as explain how the program complies with the
22 Commission's Final Orders in previous Avista general rate cases in Docket Nos. UE-991606
23 and UE-090134.

1 The incentive plan reviewed by the Commission in UE-991606 was the corporate
2 plan that covered the period from January 1, 1999 to December 31, 1999. This Plan was
3 based solely on Corporate Earnings per Share (EPS) which funded the incentive award pool
4 of dollars. If the Company met EPS at or above the threshold performance level, then 50%
5 of the funds would be allocated equally to employees based on achieving the Company's
6 goals. The other 50% would be allocated at the discretion of management based on an
7 assessment of the employee's performance and contributions during the year. Payments
8 under this Plan ranged from 0% to 200% depending on the level of performance achieved.

9 **Q. How has the Company changed its incentive program since 1999 to**
10 **address the concerns by the Commission?**

11 A. In 2001, Avista reengineered its employee incentive plan to drive strategic
12 objectives and to address concerns the Commission voiced in UE-991606 regarding the
13 incentive plan of 1999.

14 The plan that was implemented in 2002 addressed the concerns of the Commission
15 by focusing employees on controlling O&M costs per customer by improving our processes
16 and driving efficiencies to better manage the business (O&M cost per customer and capital
17 spending), while paying close attention to our customers' voices regarding the products and
18 services we provide (customer satisfaction and reliability). Avista has since continued to
19 calibrate the Plan over the years to focus employees in the direction that the Company is
20 striving for in order to benefit the customer.

21 We created an O&M cost per customer metric to focus the business on controlling
22 costs and driving efficiencies in order to keep our costs reasonable for our customers. When
23 controlling costs, sometimes there are unintended consequences, however, such as the level

1 of service drops due to budget cuts or jobs are reduced that may impact how fast we can
2 restore power to customers. In order to balance the focus of controlling costs and yet provide
3 a satisfactory level of performance for our customers, we added three performance triggers
4 to the Plan that we believe were critical to the business. First, we use a customer satisfaction
5 survey to track satisfaction levels of customers that have had recent contact with us. Second,
6 our reliability measure is the average restoration time for sustained outages. The industry
7 acronym for this measure is CAIDI - Customer Average Interruption Duration Index. Third,
8 the method previously tracked capital spending by comparing the actual capital dollars spent
9 to the capital budget. In 2004, we eliminated the capital spending trigger from the employee
10 Plan.

11 In 2005, we added another minimum performance trigger to create a more balanced
12 approach to electric reliability. The industry acronym for this measure is SAIFI - System
13 Average Interruption Frequency Index, which measures the number of customers which had
14 sustained outages (> 5 minutes), divided by the number of customers served. Not only are
15 we watching our restoration time, but we are watching how many outages our customers are
16 experiencing. By starting with a sustainable design and a philosophy to benefit our
17 customers, we have the ability to make changes to the Plan as we learn by focusing on these
18 areas year over year.

19 In 2009, we reengineered the Plan template again. We kept the same measurements:
20 O&M Cost per Customer, Customer Satisfaction, CAIDI and SAIFI, but revised the way the
21 Plan worked. Each measure became an independent component to the total incentive award
22 opportunity. Each had its own target to achieve. Avista still believes that customer
23 satisfaction and reliability of service are core objectives to our business, therefore, these

1 non-financial measures were designed as a “meets” or “not meets” metric. If the acceptable
2 standard target set is not met, then the Plan does not pay out that portion to any employee.

3 In 2010, we kept the same Plan template from 2009, but revisited the reliability
4 measure and recalibrated the methodology for creating the O&M Cost-Per-Customer target.
5 The Company combined three indices into one reliability index to be used in the Plan, and
6 added a sharing mechanism to the O & M Cost-Per-Customer target.

7 In 2011, we again kept the same Plan template from 2009 and 2010, but introduced a
8 new natural gas response time measure as a non-financial metric, providing a balanced
9 approach to both electric and natural gas reliability. The Company implemented another
10 non-financial measure called “Performance Excellence”. The Company is focused on four
11 key initiatives: Asset Management, Supply Chain, Enterprise Technology, and Work &
12 Resource Management. Each initiative has established milestones to complete and each has
13 a projected dollar value represented by net present value and/or avoided cost which may
14 occur outside three years. The Company sets a separate goal for each measurement. Both
15 measures must be achieved in order to meet this portion of the incentive award. These
16 measures include:

- 17 • Complete 92 milestones
- 18 • Achieve \$6.2 million in value

19 Once final, the Board reviews and approves the Plan each year. Annually, the
20 Company assesses the Plan to determine if modifications should be made to keep employees
21 focused in on the core business strategies of the Company. As stated above, the 2012
22 Incentive Plan design was approved in March, 2012.

23 **Q. How does the Company’s Incentive Plan benefit customers and how do**
24 **employees contribute to the results?**

1 A. Avista's Employee Incentive Plan and Executive Officer Short Term
2 Incentive Plan provide several benefits to customers. The Plans focus work groups and
3 individuals on key objectives of the Company, which are reliability, customer service and
4 cost-control. When we have all employees focused on overall cost-control, this translates
5 into lower rates by reducing the level of expense below what it otherwise would have been.

6 Employees contribute to these measures in their daily work or on special projects in
7 varying degrees. When employees are faced with problems or issues, they are engaged
8 enough to take it upon themselves to come up with solutions, such as designing squirrel
9 guards or osprey nests in order to reduce outages caused by animals, or save on printing
10 costs by defaulting all Avista printers to black and white, using double-sided print copies, or
11 choosing electronic pay statements rather than printed statements. In order to obtain
12 sustainable process improvements and efficiencies over time, it requires having all
13 employees thinking about innovation and workable solutions. Results are not always
14 quantifiable, and, in some cases result in relatively small savings, however, in total they can
15 add up to substantial amounts. The incentive plan is a tool we use to recognize employee
16 efforts in driving efficiencies and controlling costs for our customers. There are many
17 examples of productivity initiatives in recent years. Please see the testimony of Company
18 witness, Mr. Kopczynski, for additional information.

19 Process improvement is part of Avista's culture. The incentive plan design
20 contributes to the focus employees place on continually looking for more efficient ways to
21 do work, and recognizes employees for their contributions in keeping service reliable and
22 costs reasonable for our customers.

1 **Q. Does Avista's Employee Incentive Plan apply to employees who are**
2 **subject to collective bargaining agreements?**

3 A. Yes. Union employees are eligible under the same Plan as non-union
4 employees. However, Local 77 union employees are paid a flat dollar amount rather than a
5 percentage of base salary.

6 **V. EXECUTIVE COMPENSATION**

7 **Q. In the Company's most recent electric and natural gas general rate**
8 **cases, in Order No. 06, Dockets UE-110876 and UG-110877, Avista was directed to file**
9 **with the Commission information regarding Executive Compensation. Please discuss**
10 **these requirements and the Company's compliance with Order No. 06.**

11 A. Commission Order No. 06, paragraph 42, Dockets UE-110876 and UG-
12 110877, required Avista to provide the following information:

- 13
- 14 • A description of current executive compensation, including but not limited to,
15 base salary, non-equity incentive compensation, and incentive compensation.
16 This description should state what elements and amounts are included in rates
17 for the Company and what elements and amounts are not recovered through
18 rates.
 - 19 • A description of how levels of compensation are set. This description should
20 include discussion of the basis for selecting ostensibly comparable utilities
21 that were surveyed, state what those survey results showed, and explain how
22 the results relate to Avista. Avista is also required to state whether executive
23 compensation paid by any Pacific Northwest investor-owned (e.g., Puget
24 Sound Energy, PacifiCorp, et cetera) or publicly-owned utilities (e.g., Seattle
25 City Light, Tacoma Power, Public Utility District No. 1 of Snohomish
26 County, and the Bonneville Power Administration) were considered and if
27 not, explain why not
 - 28 • An explanation of why the existing levels of executive compensation are
29 appropriate for recovery in utility rates.
30
31
32

33 **Q. Did the Company file the required report?**

1 A. Yes, the Company filed a report with the Commission on February 28, 2012.

2 The report addressed the following issues:

3 1. Executive Officer Compensation Description

4 A description of executive officer compensation, including what elements and
5 amounts are included in customer rates versus amounts which are excluded from
6 customer rates.

7
8 2. Setting of Executive Officer Compensation Levels

9 A description of how levels of compensation are set, including the basis for selecting
10 comparable utilities that were surveyed, what those survey results showed, and how
11 the results relate to Avista. Additional information is included, as requested, on
12 whether executive officer compensation paid by any Pacific Northwest investor-
13 owned or publicly-owned utilities were considered comparable and if not, why not.

14
15 3. Appropriate Level of Executive Officer Compensation in Rates

16 An explanation of why the existing levels of executive officer compensation is
17 appropriate for recovery in rates.

18

19 This Review of Executive Compensation Report has been provided in Exhibit Nos.__(KSF-
20 2) and ____ (KSF-2C).

21 To summarize, Avista's overall executive officer compensation program is a mix of
22 base salary, annual incentive compensation and long term incentive awards. A portion of
23 base salaries and the short term incentive plan (described above) associated with utility
24 operations is borne by the customers, whereas all amounts focusing on shareholder value,
25 including the EPS targets in the short term incentive plan and all components of the long
26 term incentive plan are borne by shareholders. Additional executive compensation benefits
27 such as SERP and deferred compensation are also borne by the shareholder, because these
28 benefits are over and above what is offered to employees as part of their total compensation
29 package.

30 A considerable amount of time and effort goes into the development of the executive
31 compensation program. The Board of Directors has an independent Compensation

1 Committee that oversees all aspects of the executive compensation program, including base
2 salaries, STIP, LTIP, SERP/deferred compensation, and other benefits. The Compensation
3 Committee relies on additional analysis from an independent compensation expert, Towers
4 Watson, for each pay element relative to the Company's objectives, which includes a review
5 of market practices and other factors consistent with a peer group of utilities of similar size
6 and characteristics as Avista. Finally, Avista's shareholders weigh in on the program
7 through the "Say-On-Pay" vote in the annual proxy, which passed in 2011 with a 94%
8 approval rate. The level of compensation and benefits provided to executive officers is what
9 other similar utilities offer.

10 Of the total salaries and incentive pay for all officers of \$9.5 million in 2011, 41.6%
11 or \$3.95 million is currently included in retail rates on a system basis. Washington's portion
12 of the overall salaries and incentive pay for all officers that is currently included in rates is
13 \$2.4 million, or 25% of the total salaries and incentive pay.

14 Avista believes that the executive officer compensation programs are structured
15 appropriately to meet the Company's business objectives. The executive officer
16 compensation programs have played a material role in focusing the executive officer team
17 on achieving solid financial results, maintaining system reliability, and delivering
18 outstanding customer service. The compensation structure and levels serve as an appropriate
19 tool to help motivate, retain and attract a highly experienced, successful executive officer
20 team to manage the Company. Please see Exhibit Nos.__(KFS-2) and __(KSF-2C) for
21 additional information.

22 **Q: Were there additional requirements of the Company as it relates to**
23 **updates?**

1 A: Yes, the Order at paragraph 43, stated, “We also require the Company to
2 update this information at the time it files its next general rate case so that the Company’s
3 testimony can be evaluated for the prudence of Avista’s executive compensation expense
4 both in terms of the levels of compensation and the allocation of its recovery from utility
5 customers”.

6 **Q. What updates have been made in this filing?**

7 A. The information included in the report (Exhibit Nos.__(KFS-2) and
8 __(KFS-2C) was based on 2011 actual salaries and, as such, is quite current. The
9 information included in this report filed on February 28, 2012, varies slightly only from the
10 Company’s rate filing, in two ways: First, the allocated officer salaries have been updated
11 for new utility and non-utility percentages. Based on information received from each
12 executive officer, base salaries are allocated between utility and non-utility operations.
13 Annually, each executive officer determines the amount of their individual time to be
14 allocated. This allocation is based on actual experience, adjusted for any known changes for
15 the upcoming year. Throughout the year, any changes in time allocation are captured in the
16 timekeeping system. The average for 2011 allocation was approximately 91% utility and 9%
17 non-utility. While there have been no changes to the executive officers salaries in this filing,
18 the weighting of utility/non-utility has been updated to be approximately 87% utility and
19 13% non-utility. This resulted in a decrease of approximately \$12,000 electric and \$13,000
20 gas for Washington customers.

21 Second, the short term incentive amount included in the Company’s filing is based
22 on a six year average (2006-2011), totaling \$576,000 (System), whereas the amounts
23 currently included in rates is \$588,000 (System), reflecting an earlier six year average of

1 years 2005-2010. Please see Exhibit No. ____ (KSF-6C) for updated utility/non-utility
2 percentages and 2012 updated salaries.

3 **Q. Does this conclude your pre-filed direct testimony?**

4 A. Yes.