

Exhibit No. EH-3
Docket U-180680
Witness: Erin Hutson

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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TESTIMONY OF

ERIN HUTSON

LABORERS INTERNATIONAL UNION OF AMERICA

Exhibit EH-3

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WRITTEN BY

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George Stockton currently serves as the director of contractor and project management for Puget Sound Energy. In this capacity, Mr. Stockton is responsible for the company's project management, contract management, and quality assurance and inspection activities. Mr. Stockton also is responsible for the oversight of PSE's outsourcing program, including the electric and gas distribution system Service Provider contracts.

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Distribution Outsourcing – Puget Sound Energy's Experience

Outsourcing non-critical maintenance and construction can produce higher quality service at lower costs. Companies that specialize in providing outsourcing service can use economies of scale and lower cost advantages to capture an increasing share of utility construction budgets. Focusing on the core business helps drive shareholder value.

Introduction

In February 2001, Puget Sound Energy (PSE) began outsourcing its new residential and commercial system extension and system maintenance construction work on its gas and electric distribution networks to two specialized service providers. Quanta Services Inc. and Pilchuck Inc. were selected after a year-long nationwide competitive procurement process. After full implementation of the two contracts (expected next year), PSE will cease to perform this work with its own construction crews.

This new initiative is a strategic component of PSE's "Competitive Distribution Company" (CDC) asset management business model. The implementation of the model started with PSE's Delivery Business Unit (DBU) (the electric and gas distribution business line). All DBU business processes were reviewed and segregated into core and non-core functions. The DBU then reorganized around the self-performance of the retained core functions and the packaging and outsourcing of the non-core functions to qualified service providers. Both Quanta and Pilchuck were selected for their demonstrated understanding of the CDC model and for their contributions to the development of the service-provider-utility relationship. This relationship is based on a full commitment to perform all work in accordance with PSE technical and quality standards and to participate in a process of continuous improvement to support PSE's goal of being the best distribution company. During the procurement process each firm contributed to the definition of the scope of work, the process flow interface and the innovative "system unit" pricing structure. This service provider dialogue resulted in highly competitive pricing and cost savings associated with improvements in efficiency and productivity. While economic benefits are expected from this effort, a critical factor reflected in this initiative is the commitment these service providers have to high quality service. While PSE continues to own and

operate the pipes and wires part of our distribution business, the outside companies will now handle much of the work required for daily upkeep. Built on the principles of economies of scale, this new model enables PSE to focus on improved service quality at the lowest cost to customers. The anticipated efficiencies further signal the aggressive, forward-thinking position that PSE has demonstrated.

In this paper, we consider how PSE reached its decision to outsource this work, how the company defined what to outsource, the approach to selecting and contracting with the external suppliers, and our early experience in implementing the approach. In particular, we review the concerns raised by the workforce and unions and describe how we are addressing them. We begin with some background on PSE and its performance.

Background

PSE is Washington State's largest energy utility. We provide electricity, natural gas and a range of energy related services to homes and businesses throughout the Puget Sound area. Before we began transferring employees to the service providers, we employed some 2,700 full-time equivalents in the utility business. Our region includes in its industrial and commercial base the Boeing Company, Microsoft, Nintendo of America, AT&T Wireless, BP Refinery and Amazon.com. We serve approximately 924,000 electric customers and 591,000 natural gas customers, primarily in western Washington State. Approximately 300,000 customers purchase both forms of energy. Our 6,000 square-mile service territory encompasses more than half of Washington State's population and most of its major cities. To serve this customer base, we have some \$4.1 billion of electric utility plant and about \$1.5 billion of gas utility plant. PSE generates only 30 percent of its electric load and purchases the balance on the wholesale market. Consequently,

PSE owns significantly less generating plant than other utilities serving comparable loads.

Our firm intent is to be the best distribution company in terms of providing high quality service (based on customer convenience, customer choice and system safety and reliability) at lowest possible cost. Our non-production gas and electric cost per customer is one of the lowest among IOUs in the United States at approximately \$155, compared to an average of \$266 (extracted from the most recent FERC forms 1 and 2). Coupled with this low-cost delivery, we have consistently exceeded our benchmarked performance standards over the last three years on satisfaction, service and reliability (Figure 1). These performance standards were developed jointly with the Washington Utility and Transportation Commission (WUTC) and have been adopted by PSE as a principal performance indicator.

Motivation for Outsourcing and Initial Research

Historically, PSE used contractors to perform work on its distribution system, such as vegetation management, locating, and gas system leak surveying. Contractors also performed a significant amount of gas and electric system construction. During the 1990s approximately 45 percent of our construction has been accomplished through contractors and PSE crews performed the balance of the work.

In 1999, PSE started to review the potential value of outsourcing more work, in order to control our cost base as pressures continued to mount on our rate base. We wanted to evaluate what we could gain for our customers, our employees, and our shareholders through distinguishing ownership of the assets from servicing the assets – through economies of scale and through the opportunities from specialization. We established a project team called “Competitive Distribution Company” whose charter included an examination of business practices in other industries and countries.

The initial work undertaken by the project team focused on how we could most clearly draw the line between the core work of PSE and the non-core work which we would be prepared (under the right conditions) to outsource. The factors we examined included:

- Previous success in using contractors
- The range of alternatives available
- Productivity, efficiency and cost differentials
- Potential impact on system reliability and availability
- The risk of a negative impact on cus-

tomers service, and how customers might perceive any changes (e.g., limiting contractors’ work to parts of the network where a failure wouldn’t affect many customers)

- Regulatory considerations – e.g., statutory obligations that do not favor third-party performance.

From this review, we established aspects of our pipes and wires distribution business that are core to PSE. These are system planning and performance, and contractor and project management.

	Benchmark	'97 (6 mos)	'97/'98	'98/'99	'99/'00	'00/'01
Customer Satisfaction						
• Overall	>90%	√	√	√		
• Call Center	>91%		√	√	√	
• Gas Field Services	>85%	√	√	√	√	√
• WUTC Complaints	<5 per 10,000 customers	√	√	√	√	√
Customer Service						
• Calls answered “live”	>75%		√	√	√	√
• On-time appointments	>92%	√	√	√	√	√
• Disconnects for non-pay	<3.8%	√	√	√	√	√
Reliability						
• Gas emergency response	<55 minutes	√	√	√	√	√
• Non-storm outage duration	<2 hours 30 minutes	√	√	√	√	√
• Non-storm outage frequency	< 1.473 outages	√	√	√	√	√

Figure 1 PSE's achievements with benchmarked performance standards.

The following aspects remain in-house because of their direct interaction with customers, regulatory considerations, and other risk management considerations. These areas are managed in the same way as our external service providers with both cost and quality service metrics in place:

- Some parts of engineering, purchasing, and materials management
- First response and systems operations
- System control and protection
- Substations
- Customer call centers

As our review continued, we established more clearly the advantages that appropriate outsourcing would give in controlling our cost base, to employees, and in customer service. For example:

- Undertaking construction-type work on our own entails significant investment in a wide range of capital equipment. Since we do not have the scale and variety of work that construction contractors have, we found that our construction plant and equipment assets were underutilized and

that we were unable to invest in the most appropriate specialized equipment.

- Our large commercial customers already had a favorable experience dealing with contractors because they are aligned to customer needs. Contractors deal with relationships on a daily basis whereas asset-managing utilities do not.
- Contractor specialization allows them to invest in capital and process improvements to achieve higher performance and better customer service. Due to their large scale

– and involvement in work on other businesses such as cable and telecoms – contractors can readily justify improvements that would not be economical for a utility asset manager.

- Our employees who transfer to the contractors will share the benefits of these developments. Working for a contractor will give employees the potential of learning new skills, working with new technology, and using more specialized equipment.

Our Experience To Date

We decided to go forward with outsourcing in September, 2000. Since then we have selected our two service providers, implemented full transfer of the gas related work (with an excellent quality and safety record to date) and have accomplished about 45 percent of the transfer related to electric work as of October 2001. This is enabling us to enhance our first response organization to focus on trouble response, assessment and safety. This organization also initiates the dispatch of service provider second response teams for

the performance of required restoration work. Previously, our servicemen would provide notification for dispatch of PSE crews for second response. The difficulty was in maintaining the appropriate level of resources in both organizations in order to respond in a cost-effective and efficient manner. Using the service provider for second response allows the company to focus on the more critical component of first response with assurance that qualified construction crews are available to perform required system repairs.

From the beginning, we encouraged the active participation of the unions. PSE has a long history of working closely with unions and we wanted to preserve the merits of that relationship through the process of transition to outsourcing. We value the qualified workers that the unions have brought to our company. The availability of a trained, highly skilled and stable workforce is critical for us to meet the needs of our customers.

We, as a management team, concluded that the increasing volatility of the energy business and continued pressure on costs will render outsourcing a growing and important segment of work delivery for many utilities. We can see little merit in waiting for the tide of change to carry us along – there is much to be gained by being among the first movers.

Equally, we believe there is value to the unions in being involved with us as first movers; the change is inevitable. By being among the first, we can solve together the issues of transition, staffing levels, composite crews, pay and conditions. Given our belief that the service-provider sector will continue to grow, we think there is significant potential for our two key unions (United Association of Plumbers & Pipefitters and the International Brotherhood of Electrical Workers) to use the experience we gain in this effort to increase their membership elsewhere. We see some specific examples of benefits for the unions are:

- Acting as partners in the development of the strategic plan and the implementation of the service provider model
- An opportunity to develop highly competitive service provider-based labor agreements
- The potential to consider the relative merits of construction/service provider agreements against utility agreements in areas such as: specialization and efficiencies, work rule flexibility, productivity improvements, and cost savings
- Facilitating the development of and becoming

representatives of a more highly trained and skilled workforce

On the gas side of the business, PSE reached an agreement with the United Association of Plumbers and Pipefitters easily. This has allowed us already to achieve full implementation of outsourcing on the pipeline distribution network. However, the impact of the planned changes on the International Brotherhood of Electrical Workers is rather more complex and discussions continue on a number of aspects.

Let's consider some of the aspects of the selection and negotiation with contractors. From the start, we were aware that we needed special contractors for this type of outsourcing work. After substantial internal discussion, we defined the characteristics of such "right" contractors as:

- Understanding the way that PSE (or at least other infrastructure businesses) budgets work
- Having the geographic spread to match the spread of PSE's network
- The ability to scale up their operations to undertake this work and to readily absorb our employees who would transfer
- Giving its employees comparable working conditions and opportunities to ours
- Prepared to work with the uncertain nature of our workload
- Having significant non-PSE workload (since otherwise, the economies of scale could not be realized)

PSE developed an RFI that helped to select a short-list of contractors that we thought matched the above criteria. We asked this group to give substantial nondisclosure commitments so that we could openly discuss with them the likely volumes of work and the associated budgets. From there, we moved to a long discussion and negotiation phase from which we selected two contractors – one to cover the gas-only territory, and the other to cover both the electric-only and the electric and gas territory.

The nub of our contractual relationship is a fixed unit-price basis for construction. There are no guaranteed quantities to contractors – all of it is driven by needs. Hence, the contractors needed to understand the utilities planning approach, priorities, and demographics. They have to interface with the utility planning process. The contractor needs to be variable to the same extent that PSE is – no claims, no extras in accordance with standards. They will work on an average unit price with a protection/contin-

gency. They are allowed to invoke exceptions, but they will need to be restrained in the use of these contingencies. From the PSE side, we wanted this simplicity of approach to minimize our overheads and non-value-adding administration.

Other key elements of the contractual relationship are:

- Preferring a close working relationship to a low bid
- Maintaining our quality assurance in-house (the contractors react quickly to adverse QA comments)
- Establishing mutually-agreed-upon performance metrics
- Onus on the contractor to feed back information and updates on network status within a few days of work completion – or face penalties. Thereby PSE maintains knowledge on the state of the network.
- Application of PSE standards on how the work is done and delivered

In selecting which processes to outsource, we took care to not include tasks with regulatory constraints. The regulatory interest is focused on construction quality and safety, as well as the potential for savings, and the impact of the transfer of regulated physical assets to the contractors. We have shown that our service provider crews have met or exceeded the quality and safety performance of PSE in-house crews. Relative to cost savings we are confident that once the steady status is reached, contractual terms offer substantive savings over our previously developed budgets. There are transitional costs to the contractors, so the savings are reduced in the early years. We are receiving payment from the contractors for the transferred plant and equipment and are re-investing this in the utility.

Conclusion

As we proceed further down the path of outsourcing the support of our distribution network, we are becoming further convinced of its success. These are uncertain times for our sector – times that mandate an active cost and risk management focus. Accordingly, some type of restructuring through a process review is essential. In delivering this we have three guiding principles:

- Customer service is the principal focus
- Quality and safety are not negotiable
- Economies of scale and specialization improve efficiencies and reduce cost of service ■