EXHIBIT NO. ___(TMH-9T)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: THOMAS M. HUNT

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-072300** **Docket No. UG-072301**

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF
THOMAS M. HUNT
ON BEHALF OF PUGET SOUND ENERGY, INC.

JULY 3, 2008

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF THOMAS M. HUNT

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I. INTRODUCTION

Q. Are you the same Thomas M. Hunt who provided prefiled direct testimony in this proceeding on December 3, 2007, on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes. On December 3, 2007, I filed direct testimony, Exhibit No. ___(TMH-1T), and seven exhibits supporting such direct testimony, Exhibit No. ___(TMH-2) through Exhibit No. ___(TMH-8C).

Q. In addition to your qualifications previously submitted in Exhibit No. ___(TMH-2), do you have any specific experience with compensation market salary surveys?

A. Yes. Starting with my first compensation job at Security Pacific bank in 1990, I have worked with compensation market surveys. I have participated in all aspects as a user of surveys—matching company positions to survey jobs, compiling company data for submission to third party survey vendors such as Watson Wyatt and Milliman, and analyzing market survey results. I have also participated in the vendor side of surveys, as a member of the Steering Committee of the Milliman Puget Sound Regional Salary Survey from 1991 through 1998, and of the

Milliman Management And Professional Survey from 1996 through 1998.

Q. What does a survey Steering Committee do?

A. The Milliman Steering Committee members are volunteer representatives from companies that use the survey, and function as a source of suggestions for the vendor in improving the survey. The Steering Committee suggests changes to the survey's job descriptions to reflect changes in job use, or in some cases to recommend adding new jobs. The Steering Committee is involved with Milliman staff in evaluating whether to keep positions in a survey, based on the sample size of companies that have contributed data for a job. If a particular job has received few matches, the Steering Committee provides feedback on whether to modify the job description to better communicate the job's function, or confirms that the job should be eliminated. The Steering Committee also participates at Milliman's annual survey results presentation meetings.

Q. In addition to your qualifications set forth in Exhibit No. ___(TMH-2), have you completed any specialized compensation training?

A. Yes. I have completed five courses from the World at Work organization, formerly known as the American Compensation Association. Starting with my first compensation job at Security Pacific bank, I have used the World at Work educational program to provide skills training to supplement training I received from managers. In 1990, I completed two courses (Objectives, Principles and Regulation of Compensation Programs; and Quantitative Analysis for

Compensation Decision Making). In 1996, I completed one course (Elements of Sales Compensation) when I supported a national sales organization at Bank of America. In 2001, I completed two courses after joining PSE (Elements of Executive Compensation; and Strategic Communication in Total Rewards).

Q. Please summarize the purpose of your rebuttal testimony.

A. This rebuttal testimony responds to the recommendations of Public Counsel witness Michael J. Majoros, Jr. regarding executive compensation and incentive compensation; Public Counsel and The Energy Project witness Barbara R. Alexander regarding incentive compensation; and Commission Staff witness Joanna Huang regarding incentive compensation.

In Section II of my testimony, I will address claims by Mr. Majoros that PSE executive pay is excessive and escalating. Mr. Majoros has general concerns about executive pay in the United States –including an escalation of Chief Executive Officer ("CEO") pay due to a possible conflict of interest among executive compensation consultants –and misgivings about salary market surveys. I will demonstrate that, while these problems may be appropriate concerns at some of the United States' largest corporations, they are not manifesting themselves at PSE. I will demonstrate that PSE's use of market surveys, executive compensation consultants, and executive retirement programs are appropriate to PSE's labor market and have not resulted in the escalation of executive compensation. Mr. Majoros presented an incomplete picture of PSE's executive total compensation and potential payments related to the pending merger. I will complete the total compensation picture, including the portion of executive compensation paid by customers, and clarify potential payments at merger. I will also address each of Mr. Majoros' recommendations for substantial executive compensation disallowances and correct several inaccuracies in Mr. Majoros' testimony.

In Section III of my testimony, I address Ms. Huang's, Mr. Majoros' and Ms. Alexander's recommendations for adjustments to PSE's company-wide Goals and Incentive plan. I will demonstrate that PSE's Goals and Incentive plan continues the approach previously approved by the Washington Utilities and Transportation Commission (the "WUTC" or the "Commission") – an approach that establishes company-wide goals and individual goals that benefit customers.

II. REBUTTAL OF EXECUTIVE PAY ADJUSTMENTS

A. <u>The Company's Executive Pay is Competitive in the Labor Market and is Not Excessive</u>

Q. Mr. Majoros testified that executive pay – both nationally and within PSE – is excessive and escalating. Do you agree with Mr. Majoros' testimony as it relates to PSE's executive compensation?

A. No. Mr. Majoros' view is one of suspicion regarding the absolute levels of PSE executive pay. *See* Exhibit No. ___(MJM-1TC) at page 30, line 18. Mr. Majoros is of the opinion that key executive compensation programs are unnecessary. *See* Exhibit No. ___(MJM-1TC) at page 37, lines 19-20. Mr. Majoros' starting point is that national executive pay in general is too high and he implies that it has grown too high because of

(i) the use of executive compensation consultants (*see* Exhibit No. ___(MJM-1TC) at page 21, lines 5-6);

(ii) the use of market salary survey databases (*see* Exhibit No. ___(MJM-1TC) at page 30, lines 14-15); and

(iii) the use of special programs to compensate executives that are not used to compensate non-executives (*see* Exhibit No. ___(MJM-1TC) at page 37, lines 12-20).

Mr. Majoros allegations in this regard are unfounded, and I will address each in turn.

1. <u>Use of Human Resource Consulting Firms is Appropriate</u>

Q. Mr. Majoros implies that compensation consultants have conflicts of interest that lead them to raise CEO pay. Should the Commission consider the confidential surveys produced for PSE as invalid due to a conflict of interest?

A. No. Mr. Majoros supported his claims of possible compensation consultant conflict of interest by referring to the report "Executive Pay: Conflicts of Interest Among Compensation Consultants" prepared for Representative Henry A. Waxman, the Chairman of the Committee on Oversight and Government Reform (the "Waxman Commission report").[1] Mr. Majoros' use of the Waxman Commission report is flawed because (i) the report studied only 179 of the largest 250 US companies, which included no more than 16 publicly traded utility companies;[2] (ii) the report only *suggested*, and did not confirm, a possible connection between compensation consultant use and CEO pay;[3] and (iii) neither PSE nor any of PSE's executive salary market peer group were included in the report because none are large enough to be part of the *Fortune* 250.

Q. Are the Waxman Commission findings replicated in PSE's CEO or executive salary trend?

A. No. PSE's CEO was hired on January 4, 2002 and in the five-year period between January 2002 and December 2006 his total salary increase was 23%, or approximately 4.3% per year. This is dramatically lower than the Waxman Report figures of 105% at companies using consultants *without conflicts of interests* and 226% at companies defined as having the "most conflicted consultants." Also, as shown in the below table (Attachment A to the Company's Response to Public Counsel Data Request No. 362), CEO salary increases between 2003 and 2007 were similar to all other employee groups and actually lower each year than the average salary increase for IBEW represented employees.

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[1] U.S. House of Representatives Committee on Oversight and Government Reform (Dec. 2007).

[2] *See* Waxman Commission report at page 4.

[3] *See* Waxman Commission report at page 7.

Average Percent Salary Change [4]					
	2007	**2006**	**2005**	**2004**	**2003**
CEO	3.23%	3.33%	4.17%	5.11%	5.38%
Executives > $150,000	6.27%	4.46%	5.44%	3.65%	6.96%
Non-Union < $150,000	6.63%	4.68%	5.17%	4.29%	5.07%
IBEW (Union)	8.38%	7.44%	5.91%	5.25%	5.72%
UA (Union)	6.74%	0.81%	3.55%	3.85%	3.77%

Q. With regard to PSE's payments to Towers Perrin, the Board's executive consultant since 2004, would the Waxman Commission definition of "highly conflicted consultant" apply?

A. No. Across the four-year period of 2004 through 2007, Mr. Majoros himself calculated the total portion paid by PSE for non-compensation support at less than 50% of the executive compensation support. *See* Exhibit No. ___(MJM-1TC) at page 21, lines 11-12. This would be a "fee ratio" of less than 0.5 to 1, not the high multiples of 20 to 1 quoted in the report. And, in 2006 and 2007 PSE made no payments for non-compensation support, meaning that according to the definitions of the Waxman Commission, PSE has a compensation consultant without conflict of interest.

[4] Calculated for each year-end as the average of employee salary changes from prior year end. Employees hired during the year or terminated prior to the end of the year are not included.

2. <u>Use of Executive Compensation Surveys is Appropriate</u>

Q. Mr. Majoros asserts that executive compensation surveys are unreliable and contribute to the alleged escalation and excessiveness of executive compensation. Do you agree with him?

A. No, I do not agree with Mr. Majoros' assertions. He makes broad allegations that the use of these surveys is inappropriate and that they "ratchet up" executive pay because (i) the surveys are circular by nature; (ii) PSE used an incorrect peer group by choosing peer companies with more employees.

Q. Please explain why Mr. Majoros claims the surveys are circular and whether his claims are accurate.

A. Mr. Majoros claims that compensation surveys are circular for two reasons. First, he states that "a company that does not set compensation levels based on industry data would not have any incentive to participate." Exhibit No. ___(MJM-1TC) at page 27, lines 1-2. As shown in Exhibit No. ___(TMH-10), which is a list of publicly traded utility companies with revenues of $1 billion or higher,[5] the assertion that companies are not participating in salary surveys is totally

[5] Information summarized in Exhibit No. ___(TMH-10) is from SEC filings, aggregated by Equilar, an independent compensation consulting firm located in Redwood California. The companies were selected on Equilar's database by SIC code for electric and gas utility companies, and companies with revenues less than $1 billion were eliminated. PSE added columns to indicate if the company is a member of PSE's 2007 executive survey peer group, if the company participates in the Towers Perrin Energy Services Survey, the Hewitt Energy Survey, or another salary survey (based on PSE review of each company's proxy filing). For the largest companies on the list, PSE has added their rank within the 2006 Fortune 250 list used by the Waxman Commission report.

unfounded, since all publicly traded utilities with revenues over $1 billion provided information to salary surveys.

Mr. Marjoros' second idea for how a market salary survey could become circular is "if each participant sets its compensation levels at the 50th percentile or higher, such as PSE does, the average will ratchet up each year." Exhibit No. ___(MJM-1TC) at page 27, lines 2-3. His assertion would not be correct if all participants in a market peer group used the 50th percentile as a guide. Instead of accelerating, pay within such a market peer group would converge near the median of the first year's survey results. Mr. Majoros' testimony implies that PSE's approach is to use higher than the 50th percentile for setting target levels of compensation. PSE actually uses as a guideline the 50th percentile of market pay, a practice which would not escalate pay.

Q. Mr. Majoros claims that PSE's market peer group included companies that were too big. Does a review of the PSE market comparison group confirm this?

A. Mr. Majoros' statements give a misleading impression about the peer group used by PSE to guide executive compensation. PSE used a valid peer group of utility companies with scope that ranges above and below PSE's size.

Q. What is the appropriate method for choosing the peer group?

A. PSE's first criteria for inclusion in the peer group is that the company must be a utility—ideally a company with both electric and gas utility operations, such as an

Edison Electric Institute ("EEI") gas and electric index member. Secondly, the company needs to be available from the Towers Perrin survey source, which has 70% of all utilities, as also shown on Exhibit No. ___(TMH-10). Third, within this possible universe of companies, there are two scope measures that PSE considers when evaluating the appropriateness of our peer group—revenues generated and asset size. PSE includes a range of companies that generally have scope measures from one-half to twice PSE's value for the measure, a range that is a best practice.[6] Finally, the number of companies included in the peer group needs to total about 10 to 20 to ensure market matches for multiple jobs in the survey.[7]

Q. How does PSE compare to the peer group used for reviewing 2008 executive salaries?

A. The table below shows how PSE compared to the peer group used for reviewing 2008 executive salary actions.[8] PSE's revenue size was 93% of the median revenue size and PSE's asset size was 107% of the median asset size. Eight out of 17 companies were similar size or smaller than PSE relative to revenues and 12

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[6] Mercer Human Resources Consulting Perspective, April 5, 2007, Issue 61, Responsible peer group selection: A guide for identifying appropriate peers for assessing executive pay, Page 3 "appropriate peers should be approximately one-half to two times the size of the company for which peers are being developed".

[7] HayGroup, The Executive Edition, 2005, No. 2, Peer Group Selection: Best Practices, Page 2 "most companies identify 10 to 20+ comparator organizations that are used to determine competitive levels of pay"; Mercer Human Resources Consulting Perspective, April 5, 2007, Issue 61, Responsible peer group selection: A guide for identifying appropriate peers for assessing executive pay, Page 5, "a robust peer group typically would include at least 10-15 peers".

[8] Summarized from data provided in Attachment W to PSE's Response to Public Counsel Data Request No. 680.

out of 17 were similar size or smaller than PSE relative to asset size.

Peer Size Compared to PSE	Revenues	Asset Size
Larger (> 10%)	9	5
Similar Size (+/- 10%)	4	2
Smaller (<10%)	4	10
Total Peer Group	17	17
PSE as % of peer group median	93%	107%

Q. Did Mr. Majoros compare PSE's asset size to the peer group?

A. In his testimony, Mr. Majoros recognizes that PSE selected the peer groups based on revenues and assets. *See* Exhibit No. ___(MJM-1TC) at page 28, lines 5-7. He also states that the peers are larger relative to assets, but does not support his claim. *See* Exhibit No. ___(MJM-1TC) at page 28, lines 8-13. Instead he compares revenue, market capitalization, and employee count. Mr. Majoros later recommended that PSE should include "value of assets" in the measures it considers when selecting a peer group. As the table above shows, PSE used asset size in selecting its peer group and is in general larger than the peer companies relative to asset size.

Q. Why didn't PSE use employee count as one of its criteria?

A. PSE's organizational design differs from other utility companies in important ways related to employee count. Unlike many other utility companies, PSE (i) outsources its construction and crew maintenance work; and (ii) implemented a company-wide Automated Meter Reading system ("AMR"). Both of these have resulted in PSE having fewer employees than other utility companies. Also, employee count information is not as robust as other company financial scope measures, and high employee count may be an indicator of operational inefficiency. Mr. Majoros excerpted from one of Towers Perrin's confidential reports, but the other Towers Perrin report[9] shows PSE's Highest Paid Executive is between the 25th and 50th percentiles with respect to employees supervised. Finally, a company with regulated and non-regulated operations may report only one total employee count, making appropriate comparison impossible.

Q. Has PSE's use of market salary surveys resulted in a "ratcheting up" of executive pay?

A. No. In the Company's response to Public Counsel Data Request No. 362, the Company provided a spreadsheet of the CEO and management who were paid $150,000 base salary or higher, which I previously discussed. These employees were shown to have annual salary growth similar to all other employees at PSE. Mr. Majoros even acknowledged this on page 25, line 12 of his testimony, "the percent in base salary increase received by executives was similar to that received by other employees". The CEO's average salary change percentage in each year (2003 through 2007) was lower than the comparable average salary change of IBEW represented employees.

[9] PSE Response to Public Counsel Data Request No. 521, 1st Supplement, Confidential Attachment A.

3. Use of Labor Market, Including Special Programs – such as a Change in Control Plan, a Supplemental Executive Retirement Plan, and a Deferred Compensation Plan – to Compensate Executives is Appropriate

Q. What is the Company's position on the levels of executive pay and the executive pay programs?

A. The Company recognizes that there is a labor market for executive employees, just as all employees are part of the general labor market. To attract and retain executives, PSE must first understand this labor market and then offer a compensation package that is competitive. The Company has surveyed this executive labor market and found that PSE executive pay levels are market-competitive at an overall level as well as within the programs designed to deliver executive pay. By comparing PSE executive pay programs and overall pay levels to objective executive labor market data, the Company provides the Commission with the basis to confirm that PSE executive pay is reasonable.

Q. What are the elements of the executive labor market?

A. The executive labor market differs from the overall labor market because executives have greater responsibility and accountability than other employees, and in return have a different structure of compensation, including more pay at risk and higher levels of compensation opportunity. These pay for performance components link executive pay to multiple year performance, because executive leadership impacts the company in the current year and future years.

Additionally, special reporting requirements and tax regulations apply to executives.

The executive compensation structure primarily varies from other employees by having: 1) more cash incentive pay at risk, determined by market survey levels and 2) a long-term equity incentive plan ("LTIP") tied to multiple year company performance. The result of these programs is that executive compensation is higher than target when performance is above target levels, but significantly lower when performance is below target. The executive compensation structure also usually includes a Change in Control ("CIC") plan or employment agreement and executive retirement programs, such as the Supplemental Executive Retirement Plan ("SERP") and deferred compensation Plan ("DCP").

Q. Your testimony stated that PSE must first understand the executive labor market. Does Mr. Majoros' testimony indicate an understanding of the executive labor market?

A. No. In a number of places, Mr. Majoros' testimony indicates that he does not understand the realities of the executive labor market: (i) his summary of total compensation pay change (2007 verses 2006) incorrectly interprets a change in LTIP plan performance as an "escalation of pay"; (ii) his picture of total compensation from PSE Form 10-K data did not identify well known limitations of the SEC reporting requirements; (iii) his presentation of potential executive payments at merger has double-counted figures and included items specifically identified as not related to the merger; and (iv) his testimony includes inaccurate statements about PSE's executive retirement plans.

Q. Mr. Majoros identified that the total compensation reported for the Company's top executives increased 35% from 2006 to 2007 and claimed it showed executives received escalated total compensation compared to other employees. (*See* Exhibit No. ___(MJM-1TC) at page 25, lines 20-21.) Is this a "ratcheting up of pay" or normal variability in executive pay?

A. It is not a ratcheting up of pay, but the normal operation of pay for performance. The year-to-year change in reported total compensation observed by Mr. Majoros was primarily due to the performance of the Long-Term Incentive Plan (LTIP), a standard element of the executive labor market. LTIP performance results in 2006 were 17.25% of target (significantly below target)[10] while results in 2007 were 89.5% of target (slightly below target).[11] The difference in performance resulted in higher LTIP payments. As a pay for performance plan, the LTIP plan will naturally have variability in the level of payments. A "ratcheting up" of pay implies a permanent escalation of pay, which is not what happened with regard to the LTIP plan from 2006 to 2007. As I also describe below, the LTIP expenses are not included in revenue requirements, because they are paid by shareholders.

Q. In his testimony at page 23, lines 1-2, Table 1, Mr. Majoros summarized PSE total compensation from the Company's SEC 10-K filing "because [he] wanted the Commission to be fully aware of the total compensation package

[10] *See* Puget Energy's 2006 Proxy.
[11] *See* Puget Energy's 2007 SEC Form 10-K.

for these executives". (Exhibit No. ___(MJM-1TC) at page 23, lines 13-14.) Did he give a complete picture of the pay for these top executives?

A. No. Mr. Majoros has provided the SEC filing figures, but has not provided context necessary for the Commission to understand these figures within a utility regulatory context. In particular, Mr. Majoros has not calculated what percentage of executive pay is charged to customers, nor has he clarified that some of the compensation may not have actually been received by executives. When his testimony did try to explain the components of compensation included in the rate case, it was inaccurate, stating that the "long term investment plan (LTIP)" was included in the rate case.[12] The Company does not have a plan called the Long Term *Investment* Plan. To clear up possible confusion, the Investment Plan is the Company's 401k plan. The Company's matching plan contributions are included in revenue requirements. The Long Term Incentive Plan, which is often abbreviated as "LTIP" is the Company's multi-year incentive plan for executives. Its costs are not included in revenue requirements.

Q. What portion of the total compensation shown in Mr. Majoros' Table 1 is paid by customers?

A. Overall for the top six PSE executives, less than 49% of 2007 total compensation and less than 62% in 2006 total compensation was from programs charged to customers. The key variable for how much is charged to customers is the performance of the LTIP, which is 100% paid by shareholders. Exhibit No. ___(TMH-11), Part 1 is a worksheet that separates total compensation from the Summary Compensation Table according to whether it was associated with the LTIP plan. The percentages of pay shown as "% Non-LTIP" is a maximum value of what customers would pay of the total compensation. The percentage that customers pay would be lower, because it would not include time charged by executives to non-regulated work.

Q. Why is there a variance in the percentage charged to customers from 2006 to 2007?

A. In my testimony above, I explained that the 35% increase in total compensation from 2006 to 2007 was primarily caused by the increased LTIP payment, due to higher LTIP performance. The higher LTIP payment in 2007 increased total compensation and also lowered the percentage of total compensation charged to customers.

Q. Are there elements of executive compensation shown in the SEC 10-K filing that were not received by the executives?

A. Yes. The Company prepares the Summary Compensation Table according to the recently updated SEC requirements which took effect for Puget Energy with its 2006 calendar year filing, made in March 2007. The SEC reporting instructions

[12] Mr. Majoros apparently misinterpreted "Investment Plan" from Attachment A of PSE's Response to Public Counsel Data Request No. 528 and labeled it the "Long Term Investment Plan", which he then abbreviated as LTIP.

mean that what is shown on the table may not be actually received by the executive during the year. Referring to the Summary Compensation Table, the columns “Stock Awards” and “Option Awards” are not amounts actually paid to the executives in the years shown. *See* Exhibit No. ___(MJM-6) at page 2. The values shown in the table are PSE’s accounting expense in the year for any stock or option payments that were paid in the referenced year *or are expected to be paid in future years*. Both of these columns are compensation that is provided to executives through the LTIP plan, and therefore 100% paid by shareholders. Exhibit No. ___(TMH-11), Part 2, shows the detail of the stock reported versus received for each executive. In both 2006 and 2007, PSE reported accounting expense for these awards that exceeded the amounts the six executives received in the year, $1,756,772 in 2006 and $1,524,952 in 2007.

These accounting expense accrual figures are important to understand for two reasons. First, they represent estimated future payments to executives, but payments which may never actually be paid. If this happens, the Company would show a negative accrual for stock expense, and the executive’s stock award figure could be lower than actually received, or negative. Second, the accounting expense accruals make PSE current year executive compensation levels higher than they actually were by including expected future stock compensation.

Furthermore, there is a danger in overstating executive pay by combining SEC 10-K total compensation figures with projections about future pay, and therefore double-counting pay. This second concern specifically applies to compensation figures quoted by Mr. Majoros related to payments that would be received in the event of the merger.

Q. Please explain how Mr. Majoros has "double-counted".

A. In describing the potential payments PSE executives would receive after the merger, Mr. Majoros summarizes PSE's Response to Public Counsel Data Request No. 530 which estimated a payment of $4.6 million to Mr. Reynolds (for cash severance), $3.4 million to the IRS on behalf of Mr. Reynolds (for estimated excise tax payment with gross-up) and $22.63 million to Mr. Reynolds and 58 other employees (for LTIP acceleration). *See* Exhibit No. ___(MJM-1TC) at page 24, lines 7-11. But Mr. Majoros claimed these were not a complete picture,[13] and also referenced payment amounts from the Merger Proxy. However, the figures Mr. Majoros quoted from the merger proxy included values for compensation unrelated to the merger (and which were footnoted in the Merger Proxy to clarify for readers that they were not merger-related) and estimates of expected LTIP acceleration. By making reference to both PSE's Response to Public Counsel Data Request No. 530 and the Merger Proxy, and by double-counting amounts already reported on the 10-K, Mr. Majoros has exaggerated the payments expected. The table below categorizes the payments described by the Merger Proxy and PSE's Response to Public Counsel Data Request No. 530, and shows the overlap between the two, as well as overlap with the Company's 10-K filing.

[13] *See* Exhibit No. ___(MJM-1T) at page 24, lines 12-13 ("However, it should be noted that this answer provides only a narrow discussion of the compensation that PSE executives will receive if the sale is approved").

Nature of Payment	Estimated in Merger Proxy for 13 Officers	Estimated in DR 530 for 12 Officers and 46 Directors	Reported in 10-K for 6 Officers	Double Counted by Mr. Majoros' testimony at 24:6-20
Paid in 2008 after Merger Proxy filed	$ 9.0 M	$ 0.0 M	$ 4.5 M[14]	$ 4.5 M
Vested at date of Merger Proxy but not exercised	$ 2.3 M	$ 0.0 M	$ 0.1 M[15]	$ 0.1 M
LTIP vesting Acceleration	$ 13.0 M	$ 22.6 M	$ 2.3 M[16]	$ 13.0 M
Merger Related (severance & excise tax payment)	$ 7.8 M	$ 7.9 M	$ 0.0 M	$ 7.8 M

Q. What payments to Mr. Reynolds and other executives are "additional" and "a result of the sale"?

A. Mr. Majoros stated that Mr. Reynolds would receive "approximately $20 million in total compensation by the close of the sale" and for other executives it would be "estimated in the millions of dollars, as a result of the sale." Identifying these values as a result of the sale is misleading. Mr. Reynolds and other executives have received LTIP grants that had significant value at the time of the merger

[14] Value from Exhibit No. ___(TMH-11), LTIP received in 2007 and ½ of stock/option accounting expense in 2006.

[15] Value from Exhibit No. ___(TMH-11), Stock Award in 2006.

[16] Value from Exhibit No. ___(TMH-11), 2007 stock/option accounting expense and ½ 2006 stock option accounting expense.

announcement and would likely have value even if the merger does not occur. These LTIP grants have been included in Mr. Majoros' totals. The only "additional" compensation amounts that are forecast to be paid as a result of the merger are payments of $4.6 million to Mr. Reynolds for severance, $3.34 million to the IRS on Mr. Reynolds behalf for estimated excise tax (both based on Mr. Reynolds' 2002 employment agreement in the event of Change in Control) and a portion of expected LTIP acceleration for all executives. Of Mr. Reynolds' expected LTIP acceleration, $1.7 million is estimated to be the result of the LTIP performance share value change after the merger announcement. *See* Exhibit No. ____(TMH-14), which calculates the LTIP acceleration estimated for executives based on December 31, 2007 performance modifiers. The actual LTIP acceleration will not be known until the merger date. Puget Energy's stock price has dropped since December 31, 2007 and based on the June 30, 2008 price, LTIP acceleration would be considerably lower. Therefore, instead of receiving $20 million, Mr. Reynolds is forecast to receive approximately $6.3 million as a result of the merger (cash severance and LTIP acceleration value attributed to the merger). If the merger does not occur, Mr. Reynolds will not receive the severance payment and an excise tax will not be due to the IRS. If the merger does occur, these payments will be made, therefore they are "additional" compensation as a result of the merger. As also shown on Exhibit No. ___(TMH-14), approximately 80% of the LTIP acceleration value of other officers would likely be earned even if the merger does not occur.

Q. Are any of the payments that will be made to executives for LTIP acceleration or merger related payments being charged to customers?

A. No. The LTIP acceleration payments and merger-related payments to Mr. Reynolds (because of his employment agreement) are not charged to customers.

Q. Does Mr. Majoros accurately characterize the Company's Supplemental Executive Retirement Plan (SERP) and Deferred Compensation Plan (DCP)?

A. No. Mr. Majoros' portrayal of PSE's executive retirement plans is not accurate. Mr. Majoros' comments about executive retirement plans indicate that he feels they are unnecessary.[17] My testimony below, as well as Exhibit No. ___(TMH-12C), show that they are part of a market competitive package for executives. Mr. Majoros also infers that PSE's use of the Deferred Compensation plan is not ethical.[18] These inferences are not correct. PSE's Deferred Compensation Plan complies with IRS regulations for deferred compensation plans, including IRS Section 409A, and Company contributions toward executive retirement are permitted within the plan.

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[17] *See* Exhibit No. ___(MJM-1T) at page 37, lines 19-20 ("If PSE feels that such programs are necessary then they should be financed by the Company's shareholders, not its ratepayers.")

[18] *See* Exhibit No. ___(MJM-1T) at page 37, lines 17-19 ("Contributions to the Deferred Compensation Plan appear to serve the purpose of side-stepping limitations put in place by the IRS to curb excessive executive compensation"); *see also* Exhibit No. ___(MJM-1T) at page 37, lines 7-9 ("Are any additional payments made under the guise of the Deferred Compensation Plan? Yes.")

B. Discussion of Proposed Adjustments for (i) Executive Compensation for Time Spent on Non-Regulated Work; and (ii) Retirement Programs.

Q. Does Mr. Majoros propose any adjustments to executive compensation?

A. Yes. Mr. Majoros proposes two adjustments regarding executive compensation. First, he proposes adjustments for the compensation of several executives because he claims their time is spent on non-regulated work. Second, he proposes to remove all SERP and Deferred Compensation benefits. I will address both adjustments and explain why neither adjustment is appropriate.

1. Proposed Adjustments for Executive Compensation for Time Spent on Non-Regulated Work

Q. Mr. Majoros recommends adjustments for the compensation of several executives. Does the Company agree with these adjustments?

A. No. Mr. Majoros recommends eliminating all or some of the base salary included in revenue requirement for Mr. Reynolds, Mr. Valdman, Mr. Markell and Ms. O'Connor, Mr. Bussey and Ms. Harris. I will address why each of these recommended adjustments are inappropriate.

Q. What basis did Mr. Majoros use for recommending these salary adjustments?

A. Mr. Majoros testified that he reviewed Officer goals summaries provided in the

Company's Response to Public Counsel Data Request No. 31[19] and the job descriptions of director level employees reporting to the Officers. After reviewing these he recommended adjustments reducing allowed salaries "based on my judgment". Exhibit No. ___(MJM-1TC) at page 35, lines 1-2.

The accuracy of Mr. Majoros' review is questionable. For example, he testified that the job description for Mr. Bussey, a PSE Officer, showed "few customer service related responsibilities" (Exhibit No. ___(MJM-1TC) at page 33, lines 15-17) when the duties referenced are not Mr. Bussey's but actually from a Director-level employee who does not report to Mr. Bussey. Mr. Majoros had earlier in his testimony noted that PSE Officers do not have job descriptions. As a second example, Mr. Majoros testified that none of Mr. Bussey's goals benefit ratepayers. Mr. Bussey's goals in 2006 and 2007 were all related to PSE's six corporate-wide goals, and his specific goals included clear customer benefit. The percentage of goal weightings (i.e., the percentage of total incentive tied to this specific goal) were: 20% for "further strengthen public understanding and support for needed transmission and generation investments" (2006); 25% "based on lessons learned from 2006 storm … work with Operations to investigate new approaches to service delivery and community involvement" (2007); and 15% for employee development in each of 2006 and 2007.

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[19] Mr. Majoros cited to PSE's Response to Public Counsel Data Request No. 31, but the correct reference is PSE's Response to Public Counsel Data Request No. 531.

Q. How does the overall responsibility of Phil Bussey benefit the customer?

A. Mr. Bussey is the Senior Vice President of Corporate Affairs and his job responsibilities directly benefit customers. He has responsibility over Corporate Facilities, Real Estate, Corporate Affairs, Customer Service to PSE's major customers, and State and Local Government Relations. Mr. Bussey provides customer service to regulated commercial customers, and works directly with the different municipalities in order to help or resolve any issues, problems, or concerns about the Company.

Q. Does Mr. Stephen Reynolds charge 100% of his time to customers?

A. Most of Mr. Reynolds time has historically been charged to customers, but not 100%. In the current rate case and in prior rate cases, PSE's responses to data requests have shown the percent of time charged to non-regulatory activities. In the period of time when Puget Energy had been approached regarding merger discussions, Mr. Reynolds' time spent on non-regulated matters increased. Due to sensitivities about leaking a possible transaction, Mr. Reynolds did not submit time until after the merger was announced. Based on prior data responses, in a year without unusual merger activity, Mr. Reynolds would charge approximately 95% of his time to customers.

Q. How does the overall responsibility of CEO Mr. Reynolds benefit the customer?

A. Mr. Reynolds has a diversity of responsibilities that benefit the customer. My pre-filed testimony described the benefits of executive leadership for customers in term of "effectively and efficiently managed company operations" and "increased communications", *see* Exhibit No.___(TMH-1T) at page 11, lines 10-19, which can be categorized as an internal role and external role. Mr. Reynolds performs in both capacities. In his internal leadership role, Mr. Reynolds is responsible for participating in the Company's strategy development (with the Board of Directors and his Officer team), implementing the approved strategy, and leading PSE's employees and executive team. Part of the strategic direction Mr. Reynolds has led since joining the Company has been to implement and foster a culture of collaboration for the utility. As CEO, Mr. Reynolds has championed this culture change, to the clear benefit of customers, because a culture of collaboration explicitly recognizes and values customers' needs and responds to their feedback. The Company's dramatic improvement in the Bourke Surveys of Client and Constituent Satisfaction demonstrate the Company's success in increased collaboration, as well as Mr. Reynolds leadership of this change. In his external leadership role, Mr. Reynolds has consistently communicated with customers and constituents. Mr. Reynolds has made numerous public presentations to a variety of customer groups, communicating the Company's direction and listening to customer concerns. Especially during difficult times, such as major outages, Mr. Reynolds has sought to communicate the Company's concern for customers and commitment to ensure reliable service.

Q. How does the overall responsibility of Jennifer O'Connor benefit the customer?

A. Ms. O'Connor is the Senior Vice President and General Counsel, Chief Ethics and Compliance Officer. She has the responsibility to protect the Company from lawsuits and legal issues that may arise throughout the service territory, including providing ongoing training to employees about ethics and compliance. Frivolous lawsuits throughout our service territory can result in higher costs to the customer. She also manages our environmental operations and helps to ensure that PSE protects the environment that our customers rely on us to maintain in our territory and beyond.

Q. How does the overall responsibility of Bert Valdman benefit the customer?

A. Mr. Valdman, Executive Vice President and Chief Operating Officer, has overall responsibility for the operations portion of the business. This includes the Customer Service call center which is typically the first contact for most of our customers when they have concerns with their service or billing questions. He also is responsible for Sue McLain's Operations organization as she reports directly to him. He is responsible for the Information Technology department which develops and maintains PSE's entire technological operations in both hardware and software for PSE facilities as well as field operations. He also has responsibility for the entire safety and security functions of PSE which ensures we are in compliance with all federal and state regulations to protect the customer from harm. The customer benefits are considerable from the functions of Mr.

Valdman and the areas he has overall responsibility for managing. His areas represent the face of PSE to all our customers, and they act as the first point of contact for a majority of customers with most aspects of PSE's business.

Q. How does the overall responsibility of Eric Markell benefit the customer?

A. Eric Markell, Executive Vice President and Chief Financial Officer, has responsibility for PSE's accounting, finance, and treasury functions, as well as regulatory affairs. The financial areas support the customer by tracking and reporting the Company's operations according to numerous accounting standards required by federal and state agencies and regulators. The regulatory affairs group ensures PSE compliance with utility regulators, monitors tariff compliance and provides material for rate case proceedings.

Q. How does the overall responsibility of Kimberly Harris benefit the customer?

A. Kimberly Harris, Executive Vice President and Chief Resource Officer, has responsibility for PSE's Energy Resources and Energy Efficiency teams, including two Officers and ten Directors. These areas provide core benefits to customers by (i) ensuring that PSE meets customer resource needs; (ii) acquiring new sources of generation in a prudent way; (iii) effectively operating and managing the Company's growing fleet of generation resources; and (iv) conducting appropriate counterparty transactions to balance gas and electric loads. Mr. Majoros proposes removing 25% of Ms. Harris' salary from revenue requirements because of her "role as head of Federal Government Relations."

Exhibit No. ___(MJM-1TC) at page 35, line 8. This arbitrary reduction based on one function within Ms. Harris' responsibility (one director and small staff) is recommended without any support and presumes that PSE can run the Northwest's largest utility effectively for customers without managing relations with the federal government. Mr. Markell and Ms. Kimberly Harris discuss the clear customer benefits provided by the Federal Government Relations team.

Q. Mr. Majoros claims that the Director Investor Relations and the Director Structuring Asset Optimization and Analytics have "job descriptions that are clearly aimed towards shareholder benefit". (Exhibit No. ___(MJM-1TC) at page 34, lines 1-4.) Is this accurate?

A. No. The Director of Structuring Asset Optimization and Analytics fundamentally benefits customers by ensuring the Company has a team of employees with sophisticated analytic tools to optimize the use and value of all gas and electric resources, measure the risk analysis of all trading and hedging strategies, and report all Company portfolio positions. In addition, the position provides analytical support for decisions such as resource acquisition, long term planning, and maintenance timing. Without the highly technical expertise of this team, customers would not receive the advantage of the Company's effective programs for maximizing the value and managing the risks implicit in power production and trading.

The Director of Investor Relations fulfills dual roles within the Company, not just supporting Company shareholders, but also benefiting customers. The position helps ensure that the Company is understood and properly rated by bond-rating agencies. The position develops strategic communications that are shared with the Board, senior management, employees and shareholders. The position also completes required regulatory filings such as coordinating the SEC proxy filing.

2. <u>Proposed Adjustment for PSE's Retirement Programs (SERP and Deferred Compensation)</u>

Q. Mr. Majoros recommends eliminating expense from the Company's Supplemental Executive Retirement Plan (SERP) and Deferred Compensation Plan (DCP). What is the basis for his recommendation?

A. Mr. Majoros testifies that "The SERP goes far and beyond any Retirement Plan available to other Company employees, not to mention any retirement programs available to the majority of its ratepayers." Exhibit No. ___(MJM-1TC) at page 37, lines 15-17. This clearly indicates that his recommendation for whether to include expense for executives depends on whether other non-executives receive the program.

Q. Why does the Company offer the SERP and Deferred Compensation Plan to executives?

A. The overriding reason why PSE offers these two executive retirement programs is that they are needed to be competitive in the utility executive labor market. Exhibit No. ___(TMH-12C) provides the most recent market survey completed by

Towers Perrin. The SERP and Deferred Compensation Plans remain prevalent in the utility market because they offer something for both executives and employers. For executive employees, these programs allow retirement replacement incomes comparable to non-executives. For employers, the SERP and Deferred Compensation Plans facilitate hiring mid-career executives and help retain executives. Because traditional retirement plans accrue more value at the end of an employee's career, executives would lose retirement plan value if they left mid-career and did not have a SERP at the new employer. The retention aspect of the SERP plan is due to its five year vesting period, so an executive has incentive to remain at least five years. The SERP formula maximum of 50% of eligible pay is reached after 15 years of service, so after five years, executives are also incented to stay until 15 years of service. The final retention element of the SERP is that its early benefit commencement at age 55 is only available to employees who stay with PSE until age 55. Vested participants who leave prior to age 55 must wait until age 62 to begin receiving their benefit.

Q. How many of PSE's current Officers could be considered mid-career transfers?

A. Of PSE's twelve Officers as of May 30, 2008, eight joined within the last ten years and can be considered mid-career transfers.

Q. Are PSE's executive compensation programs part of market competitive pay for utility executives?

A. Yes. As described in my testimony below, the Company has assessed the market position of the SERP program and found that it is competitive.

C. <u>PSE's Executive Compensation is Market Competitive, Reasonable, and Consistent with Prior Rate Proceedings</u>

Q. What is the Commission Staff's view on PSE's levels of executive pay and the executive pay programs?

A. The Commission Staff did not recommend any adjustments to executive salary or to executive pay programs for retirement. Staff witness Joanna Huang testified that she concurred with the "levels of officer compensation PSE proposes to recover." Exhibit No. ___(JH-1T) at page 4, lines 2-4. She based her conclusions on a review of "PSE's approach from an overall reasonableness standpoint." Exhibit No. ___(JH-1T) at page 4, line 8.

Q. Has Commission Staff previously used personal judgment as a basis for how much executive salary to include in revenue requirements?

A. No. The Commission Staff has in the past based adjustments for executive salary on documented percentage of time spent working on non-regulated business. PSE has a policy to track and report this time and has provided this information in the Company's Response to WUTC Staff Data Request No. 133. Mr. Majoros has not presented sufficient support to abandon this practice in favor of a subjective assessment.

Q. How can the Commission objectively assess the compensation levels in executive labor market?

A. The Commission has two sources of objectively assessing the executive labor market: (i) confidential market surveys conducted by external consultants and (ii) publicly available data from SEC filings.

The Company participates each year in externally managed surveys of compensation for all employees, including executives, and these are a first source to objectively review cash, incentive, and equity-based pay in the executive labor market. Because the Commission had requested that executive pay be "fully developed on the record",[20] the Company proactively included external market survey results for CEO base salary, cash incentive, and LTIP in my Prefiled Direct Testimony. A chart provided at that time was created from a Towers Perrin confidential market survey that was also made available for detailed review by Commission Staff and Public Counsel. An updated version was included in PSE's Response to Public Counsel Data Request No. 680 and is attached hereto as Exhibit No. ___(TMH-13C). The annual confidential market surveys do not include estimates of the value of other executive programs, such as SERP and CIC.

[20] *See Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket Nos. UE-060266 & UG-060267, Order 08 at ¶ 97 (Jan. 5, 2007).

The value of SERP programs vary greatly based on an executive's tenure and CIC plans contain many variables regarding what might be paid in different merger and termination scenarios. Evaluating market level of these programs requires additional work to compare policy terms, which can be done through a manual review of company SEC disclosure (Compensation Discussion and Analysis and Summary Compensation Table) or through custom surveys conducted by Human Resource consulting firms. The Company's Compensation and Leadership Development Committee monitors SERP and CIC programs to ensure they are competitive and that expenditures make sense. Confidential Attachments M, R, and W to PSE's Response to Public Counsel Data Request No. 680 included Towers Perrin's reports on SERP and CIC for 2005, 2006, and 2007. The most recent report is attached as Exhibit No. ___(TMH-12C).

In addition to confidential surveys of the executive labor market, the Commission can review publicly disclosed data of top executive pay levels and program designs from SEC sources – such as the SEC's EDGAR Database – that are well known to practitioners of executive compensation. My Prefiled Direct Testimony included references to PSE's publicly disclosed SEC proxy filings. Exhibit No. ___(TMH-1T), and Public Counsel witness Majoros has included data from the Company's SEC Form 10-K that was filed after my testimony. Similar SEC data is readily available for all publicly traded utilities, including any alternative peer groups that Public Counsel would want to analyze, as shown by Exhibit No. ___(TMH-10), which was used to illustrate the peer group PSE uses.

Q. Please summarize the results of the confidential surveys as shown in Exhibit No. ___(TMH-13C) and Exhibit No. ___(TMH-12C).

A. Exhibit No. ___(TMH-13C) shows the target total direct compensation for CEO Stephen P. Reynolds. My initial observations are that Mr. Reynolds' base salary is slightly below the median market base salary, and total direct compensation is slightly above the market median. Long-Term Incentive Plan (LTIP) target compensation is the single largest element of total CEO pay. This portion of executive compensation is paid by shareholders. Additionally, Mr. Reynolds' base salary and target total direct compensation (the aggregate of base salary, cash incentive and LTIP) are above the 25^{th} percentile of the market comparison group, near the median value, and considerably below the 75^{th} percentile. This higher value of 75^{th} percentile represents the level that is higher than 75% of the companies in the peer group, which means that 25% of the peer group is still paying higher. Exhibit No. ___(TMH-12C) shows that the CIC and SERP plan were competitive with the utility peer group. In summary, the two attachments show that PSE CEO compensation is market competitive in the executive labor market.

Q. Are PSE's revenue requirements for executive compensation consistent with prior rate cases?

A. Yes. PSE's revenue requirements for executive compensation in the current rate case are consistent with prior rate cases and follow prior guidance and approval from this Commission.[21] The Company has not requested customers pay for any elements of executive pay that were not previously included in rates.

III. REBUTTAL OF INCENTIVE PLAN ADJUSTMENTS

Q. What is the Company's Goals and Incentive Plan and why is it important to PSE?

A. The Goals and Incentive Plan is a broad-based incentive plan providing opportunity and rewards to all PSE employees in return for delivery of performance, including service quality and customer service. Incentive pay is important because it supports both parts of PSE Compensation Philosophy—Market Competitiveness and Pay for Performance. Incentive Plan payments are part of a market competitive compensation program. Having the tool of incentive pay to communicate important goals, provide focus for performance and to reward performance is a key element of Pay for Performance.

Q. Has the importance of offering employees a competitive total compensation package changed from prior rate cases?

A. Yes. While offering competitive compensation has always been important, it has increased in importance during recent years. In my prefiled direct testimony I mentioned the staffing challenges facing PSE and other utilities. *See* Exhibit No. ___(TMH-1T) at page 7, lines 19-21. PSE has so far been successful in

[21] *See, e.g.*, PSE's general rate proceeding in Docket Nos. UG-040640 and UE-040641.

attracting and retaining employees. Of approximately 2,600 current PSE employees, nearly half (or 1,250) have been hired since January 1, 2002. PSE continues to actively recruit in the labor market, as do neighboring utilities, and whether the PSE's pay package remains competitive will help determine its ongoing success.

Q. Have prior Commission's orders allowed PSE's incentive compensation expense to be included in revenue requirements?

A. Yes. Order No. 06 for Docket UG-040640, UE-040641, UE-031471, and UE-03043 at paragraph 144 authorized the recovery of incentive payment costs. The authorization included recognition that earnings per share ("EPS") was part of the program. The order states "We find that while a portion of PSE's incentive plan payments turn on the Company reaching certain earnings goals, there is a second threshold for such payments that is based on service quality, safety, and reliability considerations. These are the criteria we have looked for in authorizing, or not, the recovery of incentive payment costs."

Q. Has incentive compensation expense been included in PSE's revenue requirements in rate cases after the 2004 rate case order?

A. Yes. In the Company's most recent rate case, the Company and Commission Staff agreed to the Company's calculations during settlement. "Incentive Plan— The Company and Commission Staff agree for purposes of settlement of this issue in this proceeding that the calculations presented by the Company on [page references deleted] are uncontested as presented by the Company."[22]

Q. Has the Washington Commission given guidance on allowance of incentive compensation since the 2004 PSE rate case order?

A. Yes. In the Commission's order number 4 to Docket UE-050684 and UE-050412, the Commission provided guidance on "the principles we will use in considering recovery of incentive pay"[23] by writing, "Generally, we require that an incentive payment plan provide benefits to ratepayers. Under some circumstances, we have allowed in rates payments under plans that have a dual benefit—to shareholders and ratepayers.[fn]" The Commission's reference to the footnote was to the PSE rate case order in Docket UG-040640, UE-040641 referenced above. The conclusion of the Commission's guidance regarding incentive pay was "The ultimate issue is whether total compensation is reasonable and provides benefits to ratepayers."

Q. How does PSE's Goals and Incentive Plan benefit customers?

A. My prefiled direct testimony identified three distinct benefits to customers from the Goals and Incentive Plan—1) focusing employees on key goals, 2) controlling wage growth compared to a base-salary only program and 3) providing a competitive total compensation package[24] -- but I want to emphasize the first one-

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[22] *See Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket Nos. UE-060266 & UG-060267, Order 08, Appendix B (Jan. 5, 2007).

[23] *See Wash. Utils. & Transp. Comm'n v. PacifiCorp d/b/a Pac.Power & Light Co.*, Docket Nos. UE-050684 & UE-050412, Order 04 at ¶ 97 (Apr. 17, 2006).

[24] *See* Exhibit No. ___(TMH-1T) at page 18, line 17, through page 19, line 13.

- ensuring employee focus on the key objectives of the company. The 2007 Goals and Incentive Plan summary[25] includes an overview of the program, "The Goals and Incentive Plan is designed to focus all employees on company goals and provide an incentive to be outstanding performers and creative stewards of resources. This plan supports the PSE philosophy of pay for performance." Exhibit No. ___(TMH-4).

The plan is titled the Goals and Incentive Plan, because understanding and accomplishing the Company's goals help develop an effective organization. Knowing the Company's objectives and working together to accomplish them provides a sense of purpose. Getting paid when the Company's objectives and individual/team objectives are met, adds to the power of the program. The goals that are established by Company management help accomplish employee focus. For 2007, the goals are: Enhance Customer Service, Optimize Generation and Delivery, Be a Good Neighbor, Value Employees, Own It, and Learn from the Past.

Q. Why is the level of available incentive payments based on Earnings Per Share and Service Quality Indices?

A. These two measures provide a clear summary for employees of what success means—that employees accomplish both the Company's annual objectives and continue providing good customer service. The annual budget process recognizes

[25] *See* Exhibit No. ___(TMH-4).

that it costs money to develop and maintain the utility's infrastructure and meet current and future customer needs. PSE completes a calendar year budgeting process whereby the Company forecasts expected expenses and revenues. The forecast for expenses includes expenditures on all needed activities for the year that will ensure continued safe, reliable service for customers as well as executing on required compliance and plans for future customer needs. The net result of forecast expenses and revenues from this comprehensive budgeting process is expected earnings which is easily tracked and easily understood by employees. If employees and managers are not controlling expenses per the budget, then expected earnings will not be achieved. If customer service quality measures are not met, then the accomplishment of annual objectives is incomplete.

Q. Is plan funding set at a fixed EPS each year?

A. No, the level of EPS performance needed for 100% plan funding is based on the Company's budget and assuming at least 10 out of 11 performance on SQIs. At target company earnings, the funding scale provides for 100% of each employee's incentive plan target. The level of earnings has varied from year to year as the company's budget has varied.

Q. Why does Ms. Huang suggest removing a portion of incentive compensation?

A. Ms. Huang's recommended adjustment for incentive compensation is based on the Goals and Incentive Plan's funding mechanism of EPS and SQI results. She analyzed the plan results from 2003 through 2007 and claims that above certain levels of EPS, the funding is split equally between EPS and SQI. Below a certain level of EPS, Ms. Huang states that funding is entirely from SQI results. Her adjustment is to recommend removing 50% of incentive pay in years when EPS exceeded $1.50.

Q. Ms. Huang states that "When EPS reached $1.50, the incentive pool approximately doubled." Is there a clear relationship between plan funding and the $1.50 level of EPS?

A. The relationship that Ms. Huang identifies between EPS above $1.50 in 2005, 2006, and 2007 but below in 2003, 2004, and 2005 is coincidental. In 2003 and 2004, there were multiple goals funding the pool for incentive payments, including a combined goal of EPS and SQI. In 2005, 2006 and 2007, the plan funding was based on EPS and SQI, but the target level of EPS performance was different each year. Additionally, the EPS figures included in Ms. Huang's table at JH-1T page 6 are Puget Energy level figures, not Puget Sound Energy. Also, the value shown for incentive in 2003 was the operations and maintenance portion, not total incentive payout; total incentive payout for 2003 was $3,237,441.

Q. Ms. Huang states that "when EPS is at or below $1.42, the incentive pool is based solely on SQI performance." Is there a level of EPS performance where SQI is the only funding measure?

A. There is not a level of EPS performance where SQI is the only funding measure.

As stated before, both EPS and SQI performance are needed to fund incentive payments. Ms. Huang may have based her conclusion on the fact that in the 2006 and 2007 funding scales there were regions where incentive funding had triggered at 30% of target funding level, but additional EPS did not contribute additional funding until a second threshold was reached. For 2006 this range of EPS was $1.33 to $1.38. For 2007 this range was $1.43 to $1.48. But even in these cases, EPS and SQI were calculating the pool together. Trigger level EPS was required and SQI results were still also determining whether 30% target funding, higher or lower would be available.

Q. Do you agree with Ms. Huang's statement that "EPS is tied to corporate and business performance that benefits shareholders. It is not customer-service oriented and does not benefit regulated customers," or her recommendation to remove 50% of incentive compensation expense?

A. No, I do not agree that EPS is only of shareholder benefit. Accordingly, I do not agree with Ms. Huang's adjustment. I have described above how the Company's budget and forecasts for revenue determine the level of EPS. EPS combined with SQI establish the pool for incentive awards, so at no level of plan funding has the plan's focus on SQIs been eliminated. The Commission guidance issued in the PacifiCorp Order I mentioned above[26] clearly addresses that a measure with benefit to both shareholders and customers can be allowed.

[26] *See Wash. Utils. & Transp. Comm'n v. PacifiCorp d/b/a Pac.Power & Light Co.*, Docket Nos. UE-050684 & UE-050412, Order 04 (Apr. 17, 2006).

Q. Mr. Majoros recommends eliminating all incentive compensation expense. Are his reasons the same as Ms. Huang's?

A. Mr. Majoros' main reason for recommending eliminating incentive compensation is similar to Ms. Huang's, in that Mr. Majoros claims that the plan is "first and foremost tied to financial performance measures—a shareholder benefit, not a ratepayer benefit." Exhibit No. ___(MJM-1TC) at page 40, lines 14-15. He also argues that the SQI aspect of plan funding is not sufficient to allow approval of the incentive compensation because "financial rewards can eclipse customer service failures" and customer service results could be met but still no payment made. Exhibit No. ___(MJM-1TC) at page 41, lines 7-8.

Q. What is the primary focus for funding the plan?

A. The primary focus of funding is the incentive target level. In the current plan design and prior designs, the focus has always been to fund at a level needed for market-competitive pay if performance results are accomplished. Thus, 100% accomplishment of results leads to 100% funding. Mr. Majoros' view that EPS is the primary driver of the plan because of "the fact that Mr. Hunt lists EPS as the first factor involved in computing the incentive payout" is not a meaningful analysis. The Commission is aware that EPS and SQI have together been a funding approach for PSE and have approved the approach in past rate cases. With two measures that both calculate the pool, one of them needs to be listed first.

Q. Do Mr. Majoros' concerns about SQI results being potentially eclipsed by financial results accurately represent PSE's plan or its benefit to customers?

A. No. First of all, the goals aspect of the program is seeking to motivate and incent employees to perform well operationally and with good customer service. The EPS aspect of the plan is not simply a financial goal, as I discussed above regarding Ms. Huang's recommended disallowance. Employees are not specifically focusing on EPS, nor would they know what level of annual EPS the company will likely earn until late in the calendar year, if then. Employees are motivated to perform well on SQIs without respect to the company's financial performance, because SQIs are more directly within their control, so PSE's plan would not allow employees to focus more on financial results.

In cases when EPS performance is below the established trigger and therefore does not fund an incentive pool, it is likely that customers objectives have not been met in some way, even though SQIs may have been met, because the overall company budget has fallen short. Additionally, one of the customer benefits of PSE's Goals and Incentive Plan, as I outlined in my prefiled testimony, is slower base wage growth than would occur in a base-salary only system. The variability of incentive compensation plans is the mechanism through which the base salary growth is maintained—sometimes the incentive does not pay.

Q. Does having EPS as one of the funding factors mean as Mr. Majoros suggests that "shareholders finance the program"?

A. No. PSE's incentive plan funding formula is based both on EPS and SQI performance. The EPS component only sets a potential bonus pool that is 100% modified by delivery on Service Quality Indices (SQI's) that are to the total benefit of customers. In other words, even if the EPS targets are met, not delivering on SQI's would result in less or no payment of bonuses. Also, employees are being paid because of their goal performance which benefits customers, and the method of determining available payments should not a factor in regulatory treatment.

Q. Have shareholders approved the Goals and Incentive Plan?

A. No, shareholders have not been asked to approve the plan. The plan is a management responsibility, with two instances of Board participation. First, the overall level of target incentive expense at budget is incorporated in the company budget via the funding scale that the Compensation and Leadership Development Committee ("the Committee") approve. Secondly, the Board is involved with approval of payments to the CEO and Officers. The Board approves any individual payments to the CEO, based on recommendation from the Committee. The Committee approves Officer incentive payments recommended by the CEO. The Goals and Incentive Plan not being shareholder approved is in contrast to the Long-Term Incentive Plan which was approved by shareholders in 1995 and 2005.

Q. Ms. Alexander recommends removing incentive compensation expense. Are her reasons the same as Ms. Huang's or Mr. Majoros'?

A. No. Ms. Alexander recommends removing incentive expense from rate recovery because the SQI for SAIDI was not met in 2006 or 2007. Her testimony appears to propose a change to PSE's Goals and Incentive Plan design by recommending all SQIs must be met for payment to executives.[27] However, Ms. Alexander also references the testimony of Mr. Majoros, so it is unclear whether Ms. Alexander is proposing a plan design change, or simply offering the Commission another alternative for disallowing incentives if Mr. Majoros' argument is not accepted.

Q. Should PSE's Goals and Incentive Plan be funded only if all SQI measures are met?

A. No. Ms. Alexander's recommendation to eliminate executive incentive expense, or incentive expense for PSE employees,[28] unless all 11 SQIs are achieved would compromise the Goals and Incentive Plan and harm the company's market competitive position for all employees. A basic incentive design principle is that participants must perceive they have a likelihood of accomplishing the requirements for an incentive. Ms. Alexander's change would cause employees to perceive that the incentive payment is unachievable, because while SQI

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[27] *See* Exhibit No. ___(BRA-1T) at page 38, line 1-2 ("PSE executives should not earn any incentive payment if the utility fails to meet any of the SQI performance requirements and certainly not earn 90 percent of the available incentive if 9 of the 11 metrics are met.")

[28] *See* Exhibit No. ___(BRA-1T) at page 38, lines 6-7 ("any costs associated with this incentive program".)

performance has been 8 of 10, 9 of 10, 9 of 11 or 10 of 11 during the last eight years, perfect SQI performance was not achieved. The SQI goals are not designed to be easy to meet, and requiring all to be met for any incentive payment would not be reasonable. The Company's current approach which provides an incentive for accomplishing all, providing decreases in funding for missing more than one SQI, and then removes all funding in the case of poor SQI performance, is appropriate.

Q. Does PSE's Goals and Incentive Plan meet the Commission's guidance from the Pacificorp Order No. 4 of being "reasonable total compensation" and "providing benefits to customers?

A. Yes. I have shown that the Goals and Incentive payments provide benefits to customers by focusing employees on achieving the Company's objectives for a year while ensuring good customer service and reliability. PSE's compensation philosophy is market-based and based on performance, which I feel makes it reasonable. For non-executives, Commission Staff and Public Counsel have questioned whether PSE's total compensation is reasonable. For executives, Public Counsel, but not Commission Staff, has questioned PSE's executive pay levels, but I have shown that they too are market competitive.

IV. CONCLUSION

Q. Mr. Majoros claimed that the use of executive compensation consultants escalates executive pay. Should the Commission use information from executive compensation consultants?

A. I have shown that Mr. Majoros' concerns about executive compensation consultants do not apply at PSE, and therefore, yes, I think that the Commission should use data from executive compensation consultants. Executive compensation consultants help regulated companies develop market competitive programs that attract and retain executive leaders. The Commission can easily determine if executive pay has escalated and whether any increases are unreasonable and should be excluded from revenue requirements. As I have shown in my testimony, a review of the facts specific to PSE executive pay show that it has been reasonable and provides benefit to customers.

Q. Mr. Majoros advises not using market salary surveys. Do you think the Commission should disregard market salary surveys?

A. I do not. There is a labor market for executive talent and the ability to pay appropriately requires knowledge about this market. Compensation market data surveys are a valuable tool in that they provide objective information about the market. Mr. Majoros' suggestion to not use market salary surveys is ill advised.

Q. Do you think the Commission should base decisions about whether to include expenses of programs such as SERP or Deferred Compensation according to

whether all employees are eligible for the programs or whether customers participate in similar programs?

A. No. The Commission Staff's and the Commission's approach in prior rate cases has been appropriate. The fact that some programs are limited to only a set of employees should not be the determining factor on whether the program expense is included in revenue requirements. As the Commission wrote in its Pacificorp order, each programs needs to be reviewed to see if it reasonable and provides benefits to customers. Programs such as SERP and Deferred Compensation, which are necessary for competitive pay in the labor market for executive employees should be allowed because they allow the Company to attract and retain executives, who provide benefits to customers by leading their staff, focusing employee performance on key goals, and setting the direction for meeting future customer needs.

Q. Mr. Majoros proposed eliminating from revenue requirements portions of executive salary and all executive retirement programs. Do you think the Commission should follow his recommendations?

A. No. Mr. Majoros did not support his subjective disallowance of executive base salary from revenue requirements or his assessments of executive retirement plans as unnecessary. He also failed to provide the Commission with clear information about the extent to which shareholders are already paying for executive total compensation. The Company has shown that executive pay programs are competitive with the executive labor market and that Commission Staff views the Company's executive programs – which are included in revenue requirement – as reasonable.

Q. Do you think that the Company's treatment of executive pay and incentives are appropriate?

A. Yes. PSE's recommended treatment of executive pay is consistent with prior guidance and provides an appropriate balance of customer and shareholder responsibility for executive pay. PSE's recommended treatment of incentive pay for all employees is appropriate because it provides benefit to customers.

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes.