EXHIBIT NO. ___(TMH-11T)
DOCKET NO. UE-111048/UG-111049
2011 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-111048** **Docket No. UG-111049**

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

JANUARY 17, 2012

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF THOMAS M. HUNT

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Are you the same Thomas M. Hunt who provided prefiled direct testimony in this proceeding on June 13, 2011, on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes. On June 13, 2011, I filed prefiled direct testimony, Exhibit No. ___(TMH-1T), and nine supporting exhibits, Exhibit No. ___(TMH-2) through Exhibit No. ___(TMH-10).

Q. Please summarize the purpose of your rebuttal testimony.

A. This rebuttal testimony responds to the testimony of Commission Staff witness Betty A. Erdahl, Exhibit No. ___(BAE-1T), regarding proposed adjustments to PSE's Goals and Incentives Plan costs, wage increase costs, and employee insurance costs.

In Section II of my testimony, I address the PSE Goals and Incentive Plan questioned by Ms. Erdahl, including PSE's plan design and the benefits it provides for customers. Annual incentive plans are widespread in the utility industry and have been allowed for rate recovery by the Commission in prior rate cases.

In Section III of my testimony, I address the wage adjustments and employee insurance cost adjustments proposed by Ms. Erdahl. The Company's proposed adjustments are moderate, consistent with prior rate proceedings, and allow for market competitiveness for wages and benefits.

II. DISCUSSION AND REBUTTAL OF GOALS AND INCENTIVE PLAN ADJUSTMENTS

Q. Commission Staff witness Erdahl proposes an adjustment to remove fifty percent of the Company's rate recovery of the Goals and Incentive Plan. Do you agree with this adjustment?

A. No, I do not agree with the adjustment. The Company's Goals and Incentive Plan is an important part of the total compensation program PSE uses to attract and retain qualified employees. As stated on page 3, lines 6-13 of my prefiled testimony, Exhibit No. ___(TMH-1T), the Goals and Incentive Plan is a key element of the Company's compensation policy, which has two parts: (1) pay competitively compared to the utility market; and (2) pay-for-performance. In addition to being important in attracting and retaining a skilled workforce, the program benefits customers by focusing employees on the key goals of "safety, reliability, customer service and operational efficiency"[1] and by slowing "the base wage growth that would occur in a compensation system with base salaries only."[2] The Goals and Incentive Plan should receive recovery in rates like other

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[1] Exhibit No. ___(TMH-1T) at 17:13.

[2] *Id.* at 17:15-16.

elements of employee compensation.

Q. What reasons did Commission Staff witness Erdahl give for removing fifty percent of the incentive plan expense?

A. Ms. Erdahl removed a portion of incentive pay that she arbitrarily determined was attributed to financial measures in the Goals and Incentive Plan, explaining on page 6, lines 11-13 of her testimony that: "Staff recommends that incentive pay be allowed in rates only when it is tied to service quality, because that is what benefits the ratepayers." Additionally, on page 7, lines 10-13 of her testimony, Ms. Erdahl expressed the view that "incentive compensation pay based on financial metrics benefits shareholders. Shareholders, therefore, should bear the full cost of incentive pay related to financial metrics."

Q. Did PSE provide testimony about the Goals and Incentive Plan that addressed incentive plan expense recovery and financial metrics?

A. Yes, my prefiled direct testimony included extensive discussion of the PSE Goals and Incentive Plan (pages 16 to 20) and provided the Company's reasons for offering the program, references to how the plan worked as a combination of service quality goals and a financial measure (page 19, line 14 to page 20, line 18), as well as a summary of recent Commission orders allowing incentive programs to be recovered in rates. For example, page 21, lines 8-16 of my prefiled direct testimony described how, in PSE's 2004 general rate case, the Commission specifically authorized recovery of incentive costs for the Company incentive plan, which similarly included a financial measure. Staff witness Erdahl's testimony did not address any of this testimony.

A. PSE's Goals and Incentive Plan Focuses Employees to Perform in Ways that Benefit Customers

Q. What is the Goals and Incentive Plan's financial measure and why does PSE think it is appropriate to include in the plan?

A. The Goals and Incentive Plan's funding is determined by the combination of Company results on a financial measure and the Service Quality Indices (SQIs). The financial measure is Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). My prefiled direct testimony describes on page 20, lines 15-17 why EBITDA is an appropriate measure and how the annual EBITDA target results from a thorough annual budgeting process: "The net result of forecast expenses and revenues from this comprehensive budgeting process is expected earnings, which is easily tracked and understood by employees." The annual operating plan is not simply a "financial measure" but is a summary of the expenses of and revenues from serving PSE's customers. This link benefits customers in that it ensures employees are focused on efficiency and cost control to meet this target. This ultimately is reflected in lower rates.

In explaining the financial measure to employees, PSE's communication materials state "EBITDA is a measure of cash flow that excludes the impact of financing (interest) and taxes. It is a good financial measure of employees' contribution to operating performance because it excludes the effects of factors—interest, taxes, depreciation and amortization—that are beyond most employees' control."[3] The EBITDA measure is used to focus employees on their impact on the annual operating plan. Measuring the annual EBITDA results, PSE determines whether the Company's annual operating plan was met. Employee actions are key to accomplishing the annual operating plan by keeping expenses in line with budget, efficiently maintaining and operating company generation and distribution facilities, and directly providing customer service. These types of activities are represented in the Company's annual performance goals described below.

Q. Please describe the program funding calculation and individual payment calculation.

A. The funding of the program (i.e., the level of total funds available for payment) is based on Company performance on both SQIs and EBITDA. Individual payments are determined based on employee and team performance of specific goals that are linked to Company-level goals (described below). My prefiled direct testimony describes on page 18, lines 6 to 13 how employee goals are established based on the overall company goals. An example of employee incentive award calculations is shown in Exhibit No. ___(TMH-10) at pages 6–7 (for the 2010 plan) and pages 14–15 (for the 2011 plan).

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[3] Exhibit No. ___(TMH-10) at 3 (2010 plan); *id.* at 11 (2011 plan).

Q. What are some of the performance factors besides service quality that benefit the customer and are addressed in the Goals and Incentive Plan?

A. As mentioned above and in my prefiled direct testimony, reliability, safety and operational efficiency are three additional factors in addition to service quality that benefit customers and are addressed in the Goals and Incentive Plan. The scope of the Goals and Incentive Plan is to motivate employees to achieve a broad set of performance objectives. The Company-level goals demonstrate the broad set of performance objectives. For 2010 and 2011, there were six categories of Company Goals: Enhance customer service; Optimize generation and delivery; Be a good neighbor; Value employees; Own it; and Continue to learn and grow.[4] The "Own it" category, for example, includes the statement "Take personal responsibility for meeting customer needs while using company resources and facilities wisely." This is just one example of how the Goals and Incentive Plan recognizes the dual responsibility of customer service and operational efficiency. Employees performing in this manner are clearly providing a benefit to customers.

Q. Do you agree with Ms. Erdahl that fifty percent of PSE's Goals and Incentive Plan is attributed to financial measures?

A. No. The funding for the Goals and Incentive Plan is determined by the combination of performance on service quality measures and performance on a

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[4] Exhibit No. ___(TMH-10) at 2 (2010 plan); *id.* at 10 (2011 plan).

financial measure. The tables which calculate the funding of the Goals and Incentive Plan were included in my prefiled direct testimony in Exhibit No. ___(TMH-10) at page 4 (for the 2010 plan) and page 12 (for the 2011 plan). Both service quality and the financial measure must be achieved above threshold levels for any incentive funding. The two performance measures are not independent, and having employees focus on both measures is important to communicate that success requires both meeting the SQIs and achieving operational efficiency.

Q. On page 7, lines 2-3 of her testimony, Ms. Erdahl claims that there could be less focus given to SQIs in order to meet financial metrics. How does the Goals and Incentive Plan ensure focus on the SQIs?

A. The two performance measures work together for plan funding, but the focus is clearly kept on SQI performance. Employees are motivated to achieve the SQI measures not only because they are important for customers and for the reputation of PSE, but because achieving SQIs has financial implications under the Goals and Incentive Plan. First, the plan will not fund at all if SQI performance is below 6 of 10 (2010) or 6 of 9 (2011). Second, the focus on SQIs is maintained because missing any SQI measure reduces the otherwise available incentive pool by 10% for each SQI missed. Finally, the ability to fund an incentive pool at more than 100% of the target level requires high SQI performance, with all or all but one SQI measure met.

Q. On page 6, line 23 of her testimony, Ms. Erdahl claims that the incentive plan "fails" because it is possible for no incentive funding to occur even though SQIs are met. Why does the plan have a threshold for the financial measure?

A. PSE has designed the Goals and Incentive Plan to have two thresholds of performance, set at levels where performance is defined to be minimally acceptable for any incentive payment. The incentive plan by its nature has a risk of no payment if performance is below acceptable levels. The threshold for SQIs is described above. For EBITDA, the threshold is 90% of target.

As discussed above, PSE uses EBITDA as the financial measure because it represents the desired result of the annual operating plan, which includes providing customer service at levels to meet all SQIs. If operating performance is more than 10% below expected levels, a significant reduction in revenue or overrun in expenses (or combination of both) would have occurred, and the Company would generally not make payments.[5] EBITDA performance is generally expected to fall within a 10% range around target, which is why the 90% threshold was set.

The EBITDA threshold can motivate employees to find ways to reduce costs as an offset to low revenues, as happened during the 2010 plan year when warm weather and reduced customer usage reduced revenues. Customers benefit from

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[5] *See* Exhibit No. ___(TMH-10) at 8 (general rule 8) ("The adjusted EBITDA results may be modified to eliminate the effects of one-time events or other extenuating circumstances that the CEO determines are unrelated to company performance during the plan year.").

employee cost control efforts. Employees also understand the risk that unusual events could impact Company operating performance and incentive funding, and PSE thinks that most customers would not feel it appropriate if incentives were paid when Company operating performance is below expectations.

Q. Do you agree with the claim that financial measures only benefit shareholders and should be funded exclusively by shareholders?

A. No. The financial performance measure in the Goals and Incentive Plan is impacted by how well employees exercise cost control in managing Company budgets and by the operational efficiency achieved by many departments. As I described on page 20 of my prefiled direct testimony, the Company's goal for EBITDA "is related in part to the Company's ability to control costs, stay within its budget, and operate efficiently." Customers benefit when employees focus on and achieve these results.

Q. How did Commission Staff determine the fifty percent recommended disallowance?

A. Ms. Erdahl's testimony does not state how she determined that a 50% disallowance would be appropriate for PSE's Goals and Incentive Plan.

B. PSE's Goals and Incentive Plan is Consistent with Prior Plans Approved by the Commission

Q. Has the Commission addressed incentive plans such as PSE's Goals and Incentive Plan in prior orders?

A. Yes. As described above and on page 21, lines 8-16 in my prefiled direct testimony, the Commission authorized recovery of the costs of PSE's Goals and Incentive Plan in the PSE 2004 general rate case.[6] PSE's Goals and Incentive Plan is similar to the PSE program approved in the 2004 order. More recently, the Commission addressed incentive plans in PacifiCorp's 2010 general rate case and allowed PacifiCorp to include the incentive plan expenses in rates.[7]

Q. Did Ms. Erdahl's testimony respond to either of these Commission orders?

A. No. Ms. Erdahl's testimony referred to two Avista rate cases (UE-090134, UE-991606) and two much older cases, one for Puget Power and Light (UE-920433) and one telecommunications case (US West UT-950200).

Q. Is PSE's Goals and Incentive Plan similar to any of the plans discussed in the orders cited by Ms. Erdahl?

A. PSE's Goals and Incentive Plan is not similar to the plan from the Puget Sound Power and Light case. My understanding of the Avista incentive plans is that they do not have the structure of PSE's plan, which requires funding based on

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[6] *WUTC v. Puget Sound Energy, Inc.*, Docket UG-040640, *et al.*, Order 06 ¶ 144 (Feb. 18, 2005).

[7] *WUTC v. PacifiCorp*, Docket UE-100749, Order 06 ¶¶ 248–49 (Mar. 25, 2011).

both financial and SQI measures and determines individual awards based on performance to goals that clearly benefit customers. I am not familiar with the 1995 US West plan.

Q. Are Goals and Incentive Plan payments for PSE's officers included in the amounts for incentive compensation sought for recovery from ratepayers?

A. No. PSE has not requested recovery of officer incentive expenses from the Goals and Incentive Plan. PSE did not request recovery of these expenses in the 2009 general rate case, either. As stated on page 22 lines 12-13 in my prefiled direct testimony, PSE's position is that officer Goals and Incentive Plan expenses "qualify for inclusion and have previously been reimbursed." But because of the difficult economic times, PSE has elected for this rate case not to seek recovery of what should be allowable expenses.

Q. Does PSE's Goals and Incentive Plan meet the criteria for inclusion in rates as approved in the 2010 PacifiCorp order?

A. Yes. The Commission identified three criteria to determine whether to include the incentive compensation when it is part of an appropriate "overall structure of employee compensation": (1) whether the plan offers benefits to ratepayers; (2) whether the total compensation is unreasonable; and (3) whether the compensation in total exceeds the market average. I have already addressed question 1, above.

Regarding question 2, as described previously, the incentive is an integral part of

PSE's total compensation package. Ms. Erdahl has not argued PSE's total compensation is unreasonable. Ms. Erdahl's concern is not about whether the level of pay is reasonable (which it is), but about whether rate payers should have to pay for all of the incentive pay.

Regarding question 3, PSE's compensation philosophy is to pay competitively compared to the utility market, and PSE considers "competitive" to be the median of the market in comparable utilities. No party has stated that they consider PSE's compensation to be exceeding market average. The Company participates in several annual market surveys of employee compensation and uses these surveys to review non-represented pay levels and stay competitive with the market. As described on page 5, lines 16-18 of my pre-filed direct testimony, the Company's salary increases have been in-line or below market levels.

PSE's Goals and Incentive plan meets all three of the criteria used by the Commission in the Pacificorp order.

III. DISCUSSION AND REBUTTAL OF WAGE AND EMPLOYEE INSURANCE COST ADJUSTMENTS

Q. What adjustments does Ms. Erdahl propose to wage increases and employee insurance cost increases?

A. Ms. Erdahl proposes adjusting wage increases to exclude portions of contractual union increases that would take effect after May 15, 2012. For the employee insurance expense, Staff proposes using a different participant count as well as a contractual average amount instead of the actual costs being incurred.

Q. Does PSE agree with Ms. Erdahl's proposed wage adjustment?

A. PSE is willing to accept Commission Staff's proposed wage adjustment for purposes of this rate case; however, it is PSE's position that wage increase commitments contained in collective bargaining agreements are known and measureable items as of the date when the contract takes effect, since the company is legally obligated to comply with them. In this rate case, PSE will not oppose the wage adjustment, which includes the time period up to May 15, 2012.

Q. Does PSE agree with Ms. Erdahl's proposed adjustment to employee insurance costs?

A. PSE does not agree with the proposed adjustment to employee insurance costs because it is lower than actual incurred insurance costs.

Q. Please discuss the employee insurance cost adjustments made by PSE.

A. PSE adjusts employee insurance expense to the expected average cost per participant for the rate year. This adjustment is calculated using the average rate per participant per month and applying that rate to the average participation during the test year. Test year average cost per participant per month based on average participant count was $952 for IBEW employees, $988 for UA employees and $998 for non-union employees. The detail showing these calculations can be found on page 3 of the Company’s Response to WUTC Staff Data Request No. 151, attached hereto as Exhibit No. ___(TMH-12)).

Q. Are there any differences between the Company’s and other parties’ proposals for the employee insurance cost adjustments?

A. Yes, Ms. Erdahl uses the end of period participation count in place of the average participant count used by the Company. Ms. Erdahl’s adjustment also uses as the targeted average Company cost the $953 per month per participant rate from the UA contract, rather than the actual average rate experienced by the Company for the five months ending May 2011 ($988 per month per participant) used in PSE’s adjustments.

Q. Do you agree with the use of end of period count?

A. No. In addition to being inconsistent with Commission's established treatment of employee count in prior rate cases, the end of period employee count is not a normalized measure. PSE agrees with Staff that it is appropriate to remove the laid-off employees from the participant count used in this adjustment. However, it is not appropriate to use an end of period count for the reasons stated above. Therefore, for its rebuttal adjustment, PSE is using the average participant count excluding laid-off employees of 2,817, as shown on page 5 of Exhibit No. ___(TMH-12), versus the 2,803 count used by Ms. Erdahl.

Q. Ms. Erdahl argues on page 13 of her testimony that the $953 UA contract rate should be used to adjust employee insurance costs because the contract rate is known and measurable, and any amount above that is not. Do you agree with this statement?

A. No. The UA contract rate of $953 per month represents a target forecasted average rate. It does not represent the known and measurable rate in this situation. To the extent that elections actually made under the contract result in a higher average rate per participant ($988 per month in this case), even though it differs from the contracted target rate, it clearly represents a more measurable amount than an average targeted rate that was set before the actual election patterns were known.

Q. Why is the UA contract rate lower than the UA represented group's actual employee benefit expense?

A. As noted above, the $953 UA contract rate was a target average flex credit amount per employee per month, which was agreed to in the prior UA collective bargaining agreement and continued for 2011 as part of the Company's new collective bargaining agreement. The value for 2011 was not changed because the agreement was signed in October 2010 after 2011 open enrollment materials were finalized for UA employees. As part of the agreement signed in 2010, the Company and UA agreed to a new method of calculating flex credits to start in 2012. The actual UA usage of flex credits is based on the UA employee selections of employee-only, family, and opt-out medical elections. As shown in the report on page 4 of Exhibit No. ___(TMH-12), the actual UA monthly average flex credit expense for November and December 2010 was $976.99 per employee per month. The actual UA employee flex credit expense per employee per month as of May 2011 was $989.71.

Q. Ms. Erdahl states on page 13, lines 21-22 of her testimony that "while PSE calculated an average rate per participant, there was no detailed analysis indicating why the higher average rate was paid." Do you agree with this statement?

A. No. In my prefiled direct testimony at page 11, lines 6-8, I explained that PSE employees were choosing family coverage at increasing rates and that this had the effect of higher benefit cost. Additionally, in the Company's Response to WUTC Data Request No. 151, Exhibit No. ___(TMH-12), PSE provided detailed figures of employee benefit enrollment and costs, as well as the percentage of employees electing family coverage. The report on page 3 of this exhibit shows the enrollment detail of PSE employee groups for the period of January 2011 through May 2011, which was used by PSE in establishing the average cost used for the employee insurance cost adjustment. The report on page 4 of this exhibit shows the 12 month time period from November 2010 through October 2011, demonstrating that the increasing trend continued after the May 2011 time period used for the Company's adjustment. It shows that the percentage of employees electing family coverage increased from November 2010 to October 2011 in all three employee groups, and it shows that the Company's monthly employee insurance expense average increased from $981.72 in November 2010 to $986.09 in October 2011. Both reports show detail of employee elections, the average monthly cost for each employee group (non-represented, UA and IBEW), and the percentage of employees electing family coverage.

Q. Is the average insurance cost proposed by Ms. Erdahl reasonable?

A. No, the average cost proposed by Ms. Erdahl is not reasonable because it is lower than the actual employee insurance costs being incurred when PSE filed this rate case. PSE proposes to use the average per employee per month value from the January 2011 through May 2011 time period for each employee group. These values did not attempt to factor in the continuing increase in medical insurance costs known to all employers, including the State of Washington. As mentioned on page 5, lines 5-10 in my prefiled direct testimony, Exhibit No. ___(TMH-1T), PSE is participating with other employers to try to keep the escalation of annual medical insurance costs in 2014 to no more than a 4% annual increase, a goal which is viewed as challenging by all participants.

For the reasons stated above, the Commission should reject Commission Staff's adjustment and accept PSE's adjustment as filed in its rebuttal filing. Mr. Michael J. Stranik provides the impact of this adjustment on net operating income in his prefiled rebuttal testimony, Exhibit No. ___(MJS-10T).

IV. CONCLUSION

Q. Do you think that the Company's treatment of Goals and Incentives Plan costs and employee insurance expenses are appropriate?

A. Yes. PSE's recommended treatment of the Goals and Incentive Plan costs is consistent with prior Commission guidance and provides customers with the benefit of employees focused on multiple objectives, including cost control and customer service. PSE's recommended treatment of employee insurance expenses is consistent with prior rate cases and benefits customers by keeping a stable employee base.

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes.