

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-14 _____

DOCKET NO. UG-14 _____

DIRECT TESTIMONY OF

KAREN S. FELTES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

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

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

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

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

19 **Q. Please provide a brief summary of your testimony.**

20 A. In my testimony I will provide an overview of Avista's overall compensation
21 philosophy. I will also address the issues raised recently by the Washington Utilities and
22 Transportation Commission (UTC or Commission) regarding how executive compensation
23 is set. My testimony will explain how total executive compensation is set for Avista, and

1 the appropriateness of including a portion of that compensation in retail rates. I will also
 2 provide an overview of how non-executive employee compensation and benefits are
 3 determined.

4 A table of contents for my testimony is as follows:

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12
 13 **Q. Are you sponsoring any exhibits in this proceeding?**

14 A. No.

15

16 **II. TOTAL COMPENSATION OVERVIEW**

17 **Q. Please summarize Avista's total compensation philosophy.**

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

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

- 3 • Clearly identify the specific measures of Company performance that are likely
4 to create long-term value for the Company's customers and shareholders;
5
- 6 • Structure incentive pay programs to reward specified levels of performance on
7 measures designed to help the Company achieve, among other things:
8
 - 9 • Customer service targets;
 - 10 • Operational targets;
 - 11 • Shareholder value targets;
 - 12
- 13 • Promote a culture of safety;
- 14
- 15 • Align elements of the incentive plans among all Company employees, including
16 executive officers;
- 17
- 18 • Pay competitively compared to other employers within our market;
- 19
- 20 • Provide a range of payout opportunities based on the level of achievement of
21 performance goals; and
22
- 23 • Reward outstanding performance.

24 Avista's total compensation philosophy creates focus for all employees, because a
25 portion of the overall earning opportunity is at risk. Employees, including executive officers,
26 must achieve the goals of the incentive plan for the plan to payout. This tension in plan
27 design helps incent and focus all employees on the stated goals of the Company. In order to
28 achieve this pay-at-risk compensation, employees have to keep focused on cost control,
29 customer satisfaction and reliability within the system. Avista's existing total compensation
30 plan is designed to retain current employees, while remaining competitive enough to attract
31 new employees. The pay-at-risk component of compensation is not designed to pay out the
32 full incentive opportunity every year, nor is it designed to have no payout for an extended
33 period of time. Pay-at-risk plans are designed to help focus employees on stated goals that

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

3

4

III. EXECUTIVE COMPENSATION ISSUES

5 **Q. In the most recent PacifiCorp general rate case Order¹ the Commission**
6 **expressed concerns related to, among other things, how executive compensation is set.**
7 **Also, in the Commission's Order² in Avista's last general rate case, it also expressed a**
8 **desire to more closely examine executive compensation. Would you please address the**
9 **executive compensation issues raised in the PacifiCorp case, as well as explain why the**
10 **executive compensation for Avista is reasonable and appropriate?**

11 A. Yes. On page 90 of the Commission's Order in the PacifiCorp case, the
12 Commission referenced two articles: 1) Gretchen Morgenstern, *Peer Pressure: Inflating*
13 *Executive Pay*, N.Y. Times (Nov. 26, 2006); and 2) James Surowiecki, *Open Season*, The
14 New Yorker (Oct. 21, 2013). In reviewing these articles, the articles point to additional
15 written materials that speak to the executive compensation issue. For example, the *Open*
16 *Season* article refers to a paper written by "corporate-governance experts Charles Elson and
17 Craig Ferrere." An article by these individuals entitled *Peer Groups: Understanding CEO*
18 *Compensation and a Proposal for a New Approach* was published by The Conference Board
19 in April 2013. This April 2013 article was based on, and partly excerpted from, another 50-
20 page document written by the same authors: "Executive Superstars, Peer Groups, and Over-

¹ Pages 90-91, Order 05, dated December 4, 2013, in Docket UE-130043.

² Page 30, Order 09/14, dated December 26, 2012, in Dockets UE-120436/UG-120437 and UE-110876/UG-110877.

1 Compensation – Cause, Effect, and Solution,” Journal of Corporation Law, 37.³ I have
2 provided a copy of all of these documents in my work papers filed with this case.

3 I will refer back to these articles in the following pages of my testimony, so for ease
4 of reference, I will refer to them as Articles A, B, C and D as follows:

5 Article A “Open Season”

6

7 Article B “Peer Pressure: Inflating Executive Pay”

8

9 Article C “Peer Groups: Understanding CEO Compensation and a Proposal for a
10 New Approach”

11

12 Article D “Executive Superstars, Peer Groups, and Over-Compensation – Cause,
13 Effect, and Solution”

14

15 All of these documents raise similar concerns related to executive compensation,
16 including, but not limited to, 1) whether there is an appropriate selection of peer groups for
17 external benchmarking of executive compensation, 2) whether there is an overreliance on
18 the use of external benchmarking, and 3) whether there is truly a competitive market for
19 Chief Executive Officers (CEOs), such that benchmarking against other companies to
20 determine CEO compensation is meaningful or reasonable. These articles suggest that all of
21 these factors contribute to a determination of executive compensation that is excessive.

22 **Q. Do you have any general observations about these Articles?**

23 A. Yes. It is important to recognize, first of all, that the concerns raised in all of
24 these Articles relate almost exclusively to CEO compensation. Article A (Open Season), for
25 example, is essentially a two-page article that refers only to the CEO, and makes no
26 reference to non-CEO executive compensation. Although the Article uses the term

³ (forthcoming in 2013)(<http://ssrn.com/abstract=2125979>)

1 “executive pay” a number of times, the concerns raised in the Article relate to CEO
2 compensation.

3 In the same way, the concerns with “executive pay” in Article B (Peer Pressure) are
4 also directed at CEO compensation, or in the case of Mr. Grasso, the former Chairman of the
5 New York Stock Exchange. In either case, CEO or chairman, the focus is on the top
6 executive of the company. With regard to Article C, the title is “Peer Groups:
7 Understanding CEO Compensation and a Proposal for a New Approach” (emphasis added).
8 And in reading both Articles C and D, the concerns raised are clearly related to CEO
9 compensation, and not non-CEO executive compensation.

10 The authors of Articles C and D, in particular, suggest that there is not a competitive
11 market for CEOs, and therefore, it is not appropriate to benchmark CEO pay to other
12 companies.⁴ The authors suggest, based on the data they have compiled, that when a
13 company needs to fill a vacant CEO position, most companies do not hire a CEO from
14 another company; they either promote an executive from within to the CEO position, or hire
15 a non-CEO executive from another company.

16 The important point here, is that the concerns being raised regarding executive
17 compensation, at least by these authors, is related to CEOs and not non-CEO executives. In
18 fact, these same authors recognize that there is competition for non-CEO executives,⁵ which
19 means providing competitive compensation to non-CEO executives is important to attract
20 and retain these employees.

⁴ Pages 2-4, Article C.

⁵ Page 3, Article C.

1 Setting aside the discussion of the CEO position for the moment, with regard to
2 Avista, we believe there is clearly a competitive market for non-CEO executives, and we
3 have participated in that market. Two of our current non-CEO executives – Chief Financial
4 Officer, and General Counsel – were both former non-CEO executives of other companies.

5 Later in my testimony I will explain how the Compensation Committee of the Board,
6 which includes Board members that are independent from Company management,
7 establishes the compensation for Avista non-CEO executives. This process appropriately
8 includes having outside independent consultants compile peer company data to assist in
9 establishing compensation that is competitive with those companies. The Board also
10 establishes objective performance-based measures that affect the actual compensation for
11 these executives. We believe the process used by the Board results in compensation that is
12 reasonable and appropriate.

13 **Q. What is your response to concerns raised related to the selection of peer**
14 **groups for benchmarking?**

15 A. Article B was published in 2006, and since that time there have been
16 additional mandates from the Securities and Exchange Commission related to disclosure and
17 discussion of peer groups and targeted percentiles, as well as a comparison of stock
18 performance to the peer group in proxy filings. In addition, the two major institutional
19 investor voting advisory services, Institutional Shareholder Services (ISS) and Glass-Lewis,
20 have recently began to create their own concurrent peer groups in their evaluation of
21 executive pay. These changes have resulted in a more transparent peer group selection
22 process, and an implied mandate to include such selection in compensation practices.

1 In addition, as required by the Exchange Act, Proposal 4 “Advisory Vote On
2 Executive Compensation” was included in the 2011 and 2012 Proxies. This “Say-On-Pay”
3 proposal is a non-binding advisory vote on the Company’s executive compensation. It
4 passed in 2011 with a 94% shareholder approval, and in 2012 with a 91% shareholder
5 approval, indicating that shareholders believe the executive compensation program for
6 Avista is designed appropriately.

7 We believe the transparent process carried out by the independent members of the
8 Compensation Committee of the Board in setting executive compensation, including, among
9 other things, benchmarking against an appropriate peer group of companies, establishing
10 objective performance measures, and using their informed judgment on what is in the best
11 interests of all stakeholders, which is then scrutinized by independent organizations such as
12 ISS and Glass-Lewis, and is subjected to a “Say on Pay” by Avista’s shareholders, results in
13 compensation for Avista executives that is reasonable and appropriate for all stakeholders.
14 ISS and Glass-Lewis note that the peer group data they compile is for purposes of being able
15 to compare relative pay and financial performance indicators, and is not a guide for what
16 companies would use when selecting peer group companies for competitive pay practices.

17 **Q. What is your response to the concerns related to CEO compensation?**

18 A. There are arguments on both sides of the debate on whether there is, or is not,
19 a competitive market for CEOs, and I believe it is not necessary to resolve that debate in
20 order to determine the reasonableness of the compensation for Avista’s CEO.

21 There are a number of important points in the Articles related to setting CEO
22 compensation that should be highlighted:

1 **1. Should Not be Overreliance on Benchmarking to Peer Companies**⁶

2 The Articles suggest that there should not be overreliance on benchmarking to
3 peer groups, and that the benchmarking should be just one data point in the
4 overall assessment.
5

6 **2. Compensation Committee Board Members Should be Independent**⁷

7 The Articles stressed that Board members responsible for establishing
8 compensation for the CEO should be independent of management of the
9 Company.
10

11 **3. Specific Goals and Performance Measures Should be Incorporated**⁸

12 Specific goals and performance measures should be incorporated into the
13 earnings opportunity for the CEO, and the actual compensation should be
14 dependent on the level of success in reaching those goals and measures.
15

16 **4. There is a Wide Range of Flexibility in Setting CEO Compensation**⁹

17 The Articles acknowledge that, “Setting pay is an art, not a science,” and there is
18 a significant amount of flexibility Board members should operate under in
19 establishing CEO compensation. CEO compensation should be based on the
20 unique circumstances of the CEO and the company, including a broad range of
21 factors that would affect the compensation, and Board members should use their
22 informed judgment within this flexibility to establish CEO compensation.
23

24 **5. The Culture Established by the CEO is Important**¹⁰

25 The Articles recognize that the culture of the organization is established at the
26 CEO level, and that this culture has a significant impact on all stakeholders of the
27 company. There is value associated with a positive, constructive culture which
28 can provide significant benefits to all stakeholders, and the success of the CEO in
29 establishing this culture should be considered within the flexibility and the “art”
30 of setting CEO pay.

⁶ Page 5, Article C, and Page 47, Article D

⁷ Page 5, Article C, and Page 47, Article D

⁸ Pages 5-6, Article C, and Page 48, Article D

⁹ Page 5, Article C, and Page 47, Article D

¹⁰ Page 19, Article D

1 **Q. Are these factors identified above taken into consideration in**
2 **establishing the compensation for Avista’s CEO?**

3 A. Yes, these and others. With regard to benchmarking to peers, the Board does
4 use benchmarking information with peer companies in the process of establishing
5 compensation for Avista’s CEO, but it is not the sole criteria. Goals and performance
6 measures are established and the actual pay for Avista’s CEO is directly affected by the
7 level of success related to these goals and measures.

8 The Board members responsible for establishing compensation for Avista’s CEO are
9 independent of management of the Company. These Board members have many years of
10 experience related to executive compensation matters, they are aware of the flurry of
11 communication across the country related to executive compensation, they recognize there is
12 an “art” to setting CEO pay, and that there is significant flexibility afforded Board members
13 to carry out this responsibility. The Board relies on competitive data provided from outside
14 independent consultants on peer practices as well as public proxy data. The Compensation
15 Committee uses their informed judgment to establish compensation for Avista’s CEO that is
16 reasonable and appropriate for all stakeholders, based on the unique circumstances of
17 Avista.

18 **Q. With regard to the culture of the organization established by the CEO, is**
19 **it possible to measure or understand in some way the value of the culture driven by the**
20 **CEO?**

21 A. Yes. The corporate culture established at the top by the CEO can have a
22 significant effect on all stakeholders. Company witness Mr. Morris often refers to the “four

1 legs of the stool,” and has stressed that all are important; including customers, employees,
2 shareholders, and the communities we serve.

3 The internal company culture will directly affect what employees choose to do,
4 which in turn directly affects the Company’s success in areas such as customer satisfaction,
5 the reliability of service, etc. Avista periodically surveys its employees to measure what the
6 survey refers to as “employee engagement.” The survey is used essentially to measure
7 employees’ satisfaction with their job and the Company. The results of the surveys have
8 shown a high level of employee satisfaction, which is one indicator of success regarding the
9 culture at Avista.

10 With regard to reliability of service, the Company has specific performance
11 measures in place, and continues to achieve of high level of reliability of service for its
12 customers. As Mr. Morris explained in his testimony, we survey our customers who have
13 contacted Avista related to customer service or field service on a quarterly basis to measure
14 customer satisfaction. Our overall customer satisfaction from these “voice-of-the-customer”
15 surveys in the fourth quarter of 2013 was 95% in our Washington, Idaho, and Oregon
16 operating divisions. Our ratings for the past two years have been at 93% or above. These
17 ratings reflect a positive experience for customers who have contacted Avista related to the
18 customer service or field service they received. These results, which can be achieved only
19 with very committed and competent employees, are another indicator of a successful
20 corporate culture. One way to measure specific value or benefits to customers from the
21 culture established by the CEO is to look at specific examples of major decisions made by
22 the Company, and the effect those decisions have on customers of the Company.

1 **Q. Do you have some specific examples?**

2 A. Yes. The leadership at Avista has made a number of decisions recently that
3 have resulted in substantial benefits to its customers, and in some cases the decision was at
4 the expense of shareholders, i.e., customers realized significant benefits and shareholders
5 either incurred costs or passed up benefits as a direct result of the decision. The decisions
6 below are significant in the assessment of the value that the CEO of Avista brings to the
7 customers of Avista, and should not be glossed over.

8 For example, Mr. Morris in his testimony explained the multi-year legislative effort
9 led by Avista to qualify Kettle Falls as an eligible renewable resource in meeting the
10 renewable portfolio standard requirements of the Washington State Energy Independence
11 Act (I-937). This change in law, signed in March 2012, will save customers between \$6.7
12 \$12.9 million annually, related to new investment that would otherwise need to be made.
13 The annual cost avoided by Avista's Washington customers is approximately between \$4.4
14 and \$8.4 million per year.

15 The costs of these legislative efforts are borne by shareholders not customers, and in
16 addition to bearing these costs, the Company passed up the opportunity to simply build or
17 acquire the additional resources to comply with the prior law, earn a return for shareholders
18 on the new investment, and pass the costs on to customers through increased rates. The
19 decision to pursue this outcome was made by Avista's CEO, and is a reflection of the culture
20 he is driving to keep costs to customers as low as reasonably possible.

21 A second recent example is related to the Reardan Wind Site and the Palouse Wind
22 Project. Avista purchased the Reardan Wind Site for the purpose of installing renewable
23 wind generation to comply with the requirements of I-937, and the project was demonstrated

1 to be the least cost resource through a request for proposal (RFP) process. By choosing to
2 delay the Reardan Project in 2010, Avista was able to later take advantage of much lower
3 cost wind generation, which resulted in annual cost savings for the Company's Washington
4 electric customers on the order of magnitude of \$7.2 million per year.

5 Furthermore, because the Palouse Wind Project is a purchased power agreement,
6 Avista receives no earnings associated with acquiring the output from that Project.
7 Therefore, Avista not only provided substantial cost savings to customers, but also passed up
8 the opportunity to invest in the Reardan Wind project, and earn a return for shareholders on
9 what would have been a substantial investment.

10 There are many other examples that I could point to that are a reflection of the
11 culture Mr. Morris is driving to keep costs to customers as low as reasonably possible,
12 achieve high customer satisfaction and high employee satisfaction, while at the same time
13 striving for a reasonable return for the shareholders of the Company; all of which should be
14 taken into consideration in the determination of the appropriate level of compensation.

15 The point here is that Avista's customers are realizing substantial benefits from the
16 CEO at Avista making it a priority to keep costs for customers as low as reasonably
17 possible. In just the two examples above, Avista's Washington customers are benefitting
18 from over \$11.6 to \$15.6 million annually of avoided costs in their utility bills.

19 **Q. What portion of CEO pay is assigned to utility customers?**

20 A. The portion of annual CEO salary and incentive compensation assigned to
21 Washington utility customers is approximately \$386,000 for Washington electric service,
22 and approximately \$109,000 for Washington natural gas service. A portion of the CEO

1 compensation is charged to customers in Idaho and Oregon, and the remainder is covered by
2 Avista's shareholders.

3 It is important to recognize the proportion of Avista's CEO compensation covered by
4 customers vs. shareholders. The total salary and incentives for Avista's CEO reported in its
5 Proxy issued February 27, 2013 was \$2,339,800. The total salary and incentives assigned to
6 electric and natural gas customers in all three states Washington, Idaho and Oregon is
7 \$812,207. Therefore, utility customers are assigned approximately 35%¹¹ of Avista's CEO
8 compensation, with the remaining 65% being borne by shareholders.

9 Taking into consideration the process, review and oversight that goes into the
10 development of Avista's CEO compensation, and with regard to Avista's customers,
11 considering the value and benefits to customers from just the recent decisions by the CEO,
12 we believe the CEO compensation proposed for recovery in retail rates is reasonable and
13 appropriate.

14

15 **IV. HOW AVISTA'S EXECUTIVE COMPENSATION IS SET**

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

17 A. The Compensation Committee of the Board of Directors is responsible for
18 reviewing and approving, as well as overseeing the risks associated with, compensation and
19 benefits of executive officers of the Company. The overall guiding principle is that an
20 effective total compensation plan should be structured to focus executive officers on the
21 achievement of specific goals set by the Company and reward executive officers for
22 achieving those goals. Goals are intended to focus executives on the achievement of the

¹¹ Washington customers are assigned approximately 21% of total Avista's CEO salary and incentives.

1 Company's specific annual, long-term, and strategic goals and align executives' interests
2 with those of customers and shareholders by rewarding performance that meets and/or
3 exceeds Company operational goals and maintains and improves shareholder value.
4 Considerable time is spent weighing various design options to ensure that top management
5 compensation is primarily performance-based, fair and reasonable, while not encouraging
6 key decision makers to take excessive risks.

7 The Compensation Committee is composed of independent directors as defined by
8 the rules of the New York Stock Exchange, and in addition, complies with the "outside
9 director" requirement of Section 162(m) of the Internal Revenue Code of 1986, as amended
10 (the Code), and the "non-employee director" requirement of Rule 16b-3 under the Exchange
11 act. Board members are elected based on factors that are in the best interest of the
12 stakeholders of the Company including the knowledge, experience, integrity, and judgment
13 of each candidate; the potential contributions of each candidate to the diversity of
14 backgrounds, experience and competencies that the Board desires to have represented; each
15 candidates' ability to devote sufficient time and effort to his or her duties as a director;
16 independence and willingness to consider all strategic proposals and other criteria
17 established by the Board, as well as any core competencies or technical expertise necessary
18 to staff Board Committees. The Company's compensation policies and practices do not
19 include factors which create risks that are reasonably likely to have a material adverse effect
20 on the Company.

21 The Compensation Committee believes that the compensation of our senior
22 executives should be a combination of base pay and pay at risk/variable performance-based,
23 with a significant portion of their compensation related to achievement of specific goals for

1 corporate performance that are likely to produce long-term customer and shareholder value.
2 The short term incentive plan (STIP) was designed to align the interests of senior
3 management with both customer and shareholder interests in order to achieve overall
4 positive financial and operational performance for the Company. The performance metrics
5 for the STIP are based on factors that are essential for the long-term success of the
6 Company, and with the exception of the earnings-per-share (EPS) goals, are identical to
7 performance metrics used in the Company's annual cash incentive plan for non-executive
8 employees. These metrics are designed to be reasonably achievable with strong management
9 performance. Maximum performance levels are designed to be difficult to achieve given
10 historical performance and forecasted results at the time the metrics are approved. The
11 Compensation Committee believes that having similar metrics for both the executive short
12 term incentive plan (STIP) and the non-executive employee annual incentive plan
13 encourages employees at all levels of the Company to focus on common objectives.

14 The factors that influence the Compensation Committee's decisions regarding base
15 salary include: responsibilities and job complexity, experience and breadth of knowledge
16 and competitive pay among executives in the utility and diversified energy industry. In
17 addition, individual goals are established and the attainment of these goals is reviewed in
18 annual performance reviews prior to any changes in base pay. Stated goals and targets
19 generally relate to strategic planning, financial performance, safety targets, energy resource
20 management, regulatory matters, succession planning, government and customer value. The
21 Compensation Committee also reviews the results of the Company's 360-degree survey.
22 This is a standardized performance survey conducted every other year on multiple

1 leadership performance categories which include feedback from peers within the Company,
2 direct reports and the executive's direct manager.

3 **Q. Please describe how the Company utilizes Peer Group data.**

4 A. As described above, a number of internal factors such as individual and
5 Company performance goals, succession planning, job complexity, experience, and breadth
6 of knowledge are all considered when developing the overall pay structure of the executive
7 officer group. Developing an overall compensation structure and the ability to sufficiently
8 monitor and evaluate goals is a very difficult, complex and dynamic process. It is not always
9 a process based on a scientific step-by-step approach but often is attributed to factors which
10 cannot be directly quantified such as the value inherent in the "investment" in an executive
11 who has been here for a long period of time, or the value in preserving company culture by
12 promoting from within. The Compensation Committee of the Board of Directors is charged
13 with making those difficult decisions in an independent capacity.

14 In addition to these internal factors, the Company utilizes external peer group
15 analysis to benchmark its executives against a group of companies with similar business
16 profiles, similar revenue size and market capitalization. These companies can reasonably be
17 assumed to be companies with which we compete for talent.

18 The Compensation Committee works with its consultant to conduct an annual
19 competitive review of its total compensation program. Through the review process, the
20 Compensation Committee generally targets overall compensation levels (base, short-term
21 incentive and long-term incentives) within +/-15% of the median of the peer group. Pay
22 components may vary higher or lower than the median depending on an individual's role,

1 responsibilities, and performance within the Company. The Compensation Committee
2 believes this target positioning is effective to attract and retain our executives.

3 Annually each element of total compensation, which includes base salary, annual
4 cash incentives, and long-term incentives, is compared against a peer group of companies
5 which represent Company competitors for executive talent. The following factors are
6 considered in peer group selection:

- 7 • Relative Peer Company Scope – Revenue and Market Capitalization
- 8 • Industry Focus and Operational Focus
- 9 • Attainability and Quality of pay data
- 10 • Statistical Valid Sample
- 11 • Compensation Committee Selection Approval

12 The Compensation Committee uses a variety of sources of data to help it make
13 informed decisions about market compensation practices.

14 **Q. Please describe the Executive Short Term Incentive Plan (STIP)**

15 A. As I explained earlier, the STIP is designed to align the interests of
16 executives with both customer and shareholder interests in order to achieve overall positive
17 financial performance for the Company. The STIP is a pay-at-risk plan whereby employees
18 are eligible to receive cash incentive pay if the stated targets are achieved.

19 The STIP has four operational components, plus two EPS components. The total
20 amount associated with utility operational components is 40% and is broken down as
21 follows: 20% O&M Cost-Per-Customer, 8% Customer Satisfaction, 8% Reliability, and 4%
22 Response Time. The EPS components account for 60% of the total opportunity and are
23 broken out into 50% utility EPS and 10% non-utility EPS. Only the operational components

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

4 **Q. Please describe the Executive Long Term Incentive Plan (LTIP)**

5 A. The Executive Officer Long Term Incentive Plan (LTIP) is designed to align
6 the interests of executives with shareholder interests in order to achieve overall positive
7 financial performance for the Company. The LTIP is a pay-at-risk plan whereby executive
8 officers are eligible to receive common stock and dividend equivalents if the stated targets
9 are achieved. The costs associated with LTIP are borne entirely by shareholders and
10 excluded from retail rates.

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

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

- 15 1. Supplemental Executive Officer Retirement Plan (SERP):
16 In addition to the Company's retirement plan for all employees, the Company
17 provides additional pension benefits through the SERP to executive officers of the
18 Company who have attained the age of 55 and a minimum of 15 years of credited
19 service with the Company. For employees who become executive officers after
20 February 3, 2011, the SERP benefit only restores the benefit which would otherwise
21 be payable from the retirement plan due to the limitations under IRC Sections
22 401(a)(17) and 415. The costs associated with SERP are excluded from retail rates.
23
- 24 2. Deferred Compensation:
25 The Executive Officer Deferred Compensation plan provides the opportunity to defer
26 up to 75% of base salary and up to 100% of cash bonuses for payment at a future
27 date. This plan is competitive in the market, and provides eligible employees and
28 executive officers with a tax-efficient savings method. The costs associated with
29 Deferred Compensation are excluded from retail rates.
30
- 31 3. Perquisites:

1 Because the total compensation program for executive officers is fair and market
2 competitive, the Company does not provide any additional benefits in the form of
3 perquisites to the CEO or any other officer.
4

5
6 **V. NON-EXECUTIVE EMPLOYEE COMPENSATION**

7 **Q. Please provide an overview of how non-executive employee**
8 **compensation is set.**

9 A. In setting non-executive employee compensation, competitive market data is
10 monitored on an on-going basis to ensure the total program is competitive and at the same
11 time is cost-effective.

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

22 In May 2013, the Compensation Committee agreed to set a minimum salary increase
23 for non-union employees of 2.5% for 2014, based on the survey data received. In November
24 2013 based on updated market data, 2.8% for non-union employees was ultimately approved

1 to be effective March 1, 2014. In May 2014 a minimum wage increase for 2015 will be
2 presented to the Compensation Committee for non-union employees for approval.

3 As explained by Ms. Andrews, the non-union wage increase of 2.8% has been
4 included in this filing for 2014 and 2015. Union increases are governed by contract terms.
5 Negotiations are currently underway with the current contract expiring on March 25, 2014.
6 Estimates were used for both 2014 and 2015.

7 **Q. Please provide an overview of the Company's non-executive employee**
8 **incentive plan.**

9 A. In accordance with the Company's overall compensation design to align
10 elements of incentive plans among all Company employees and executives, the non-
11 executive Employee Incentive Plan (Plan) has essentially the same stated goals as the STIP
12 discussed above. Both plans help incent and focus employees on stated goals while
13 recognizing and rewarding employees for their contributions toward achieving those goals.
14 The Plan is essentially the same as the STIP, with two exceptions:

- 15 • The EPS measures discussed above are not included in the non-executive
16 employee incentive plan.
- 17
- 18 • The operations component contributions are weighted differently.

19 The weightings for utility operations are as follows: 60% O & M Cost-Per-Customer,
20 15% Customer Satisfaction, 15% Reliability Index and 10% Response Time. Annually, the
21 Company will assess the non-executive employee incentive plan to determine if
22 modifications should be made to keep the employees focused on the core business goals of
23 the Company.

1 **VI. EMPLOYEE BENEFITS**

2 **Q. Please provide an overview of the Company's overall employee benefit**
3 **plans.**

4 A. As part of the overall compensation package, the Company offers
5 competitive benefit plans for employees to meet, among other thing, medical and retirement
6 needs. We believe these programs are crucial components in attracting, retaining and
7 motivating the skilled workforce required to efficiently and effectively operate within our
8 industry.

9 The Company offers a competitive benefits package, designed to be competitive in
10 the market, including a defined benefit pension plan, defined contribution 401(k) plan,
11 medical, dental and vision coverage, company-paid term life insurance, disability insurance,
12 paid time off and paid holidays. Employees have several choices to elect benefits, such as
13 medical and life insurance, so that they can determine the best fit for their circumstances.

14 Current employees are eligible to participate in the Company's pension plan, based
15 upon employees' compensation and years of credited service, and 401(k) plan which
16 provides for Roth after-tax and/or tax deferred savings as well as the opportunity for
17 matching dollars. Effective January 1, 2014 new non-union employees are no longer eligible
18 to participate in the pension plan.

19 The Company sponsors a self-funded medical benefit plan that provides various
20 levels of coverage for medical, dental and vision, and miscellaneous other benefits such as
21 an employee assistance program and tuition assistance. Wellness programs are also offered
22 to incent employees to take control of their health care decisions and make lifestyle choices
23 in order to avoid future health care issues and keep medical costs from increasing.

1 The Company's benefit programs are designed to be flexible, cost-effective and
2 competitive with other organizations in the utility industry. The Company regularly
3 monitors the competitiveness of our benefits plans with the help of independent
4 compensation consultants Towers Watson and Mercer. These consultants provide value
5 indices and benchmark data against a peer group of Companies within which Avista
6 competes for talent. Comparable benefit data reviews are also conducted periodically with
7 other regional utilities. With over half of the Company's employee population unionized, the
8 bargaining process and contract terms, are taken into consideration in the development of,
9 and changes to, any benefit components.

10 **Q. What is the reason for the decrease in pension costs from the test year to**
11 **2015?**

12 A. The Company's pension expense is determined in accordance with
13 Accounting Standard Codification 715 (ASC-715), and has decreased on a system basis
14 from approximately \$26.6 million for the actual test year (twelve months ended June 2013)
15 to \$19.8 million for 2014. The decrease in pension cost is primarily due to on-going
16 Company contributions to the Plan (to improve the funding status) and an increase in the
17 discount rate used in calculating the pension expense and liability. For the period 2008
18 through 2013, the Company contributed over \$200 million to the plan. Additionally, the
19 discount rate used to calculate the pension cost increased from 4.15% in 2012 to 5.10% in
20 2013. The discount rate is derived by identifying a theoretical settlement portfolio of high
21 quality corporate bonds sufficient to provide for a pension plan's projected benefit payments
22 in accordance with accounting standards. The high quality corporate bonds are selected from
23 the AA or Aa bond universe (as rated by S&P and Moody's respectively).

1 **Q. What is contributing to the increase in medical expense?**

2 A. Medical insurance and post-retirement medical costs have increased, on a
3 system basis, from \$30.8 million for the actual test year for the twelve months ended June
4 30, 2013, to \$34.13 million for 2014. The increase in 2014 represents medical trend and
5 utilization expectations as well as accounting for Health Care Reform mandates such as the
6 Patient-Centered Outcomes Research Institute fee (PCORI) fee and the Reinsurance fee.
7 Our aging population within our plan continues to impact our claims experience. Also,
8 retiree utilization and expense continue to be a concern and changes to post retirement
9 medical for non-union retirees were announced in October 2013. These increases in Medical
10 have been offset by a decrease in ASC715 post-retirement medical expenses. The primary
11 drivers in this decrease are related to the increase in the discount rate and the changes to the
12 retiree medical plan described below.

13 **Q. Does the Company regularly review the competitiveness of its benefit**
14 **plans? Has the Company made changes to its retirement plans?**

15 A. Yes. We regularly monitor the competitiveness of our benefits plans with the
16 help of independent compensation consultants. Comparable benefit data reviews are also
17 conducted periodically with other regional utilities. We reviewed our benefit plans in 2013
18 and made the following changes:

19 In October 2013, we revised our defined benefit pension plan such that, as of January
20 1, 2014, the plan will be closed to all non-union employees hired or rehired by Avista on or
21 after January 1, 2014. All actively employed non-union employees that were hired prior to
22 January 1, 2014, and are currently covered under the defined benefit pension plan, will
23 continue accruing benefits as originally specified in the plan. A defined contribution 401(k)

1 plan will replace the defined benefit pension plan for all non-union employees hired or
2 rehired on or after January 1, 2014. Under the defined contribution plan we will provide a
3 non-elective contribution as a percentage of each employee's pay based on his or her age.
4 This defined contribution is in addition to the existing 401(k) contribution in which we
5 match a portion of the pay deferred by each participant. In addition to the above changes, we
6 have also revised the lump sum calculation effective January 1, 2014, for non-union
7 participants who retire under the defined benefit pension plan. The lump sum amount is
8 equivalent to the present value of the annuity based upon applicable discount rates.

9 **Q. Has the Company also made changes to its medical plan?**

10 A. Yes. In October 2013, we revised the health care benefit plan. For non-
11 union employees hired or rehired on or after January 1, 2014, upon retirement we will no
12 longer provide a contribution towards his or her medical premiums. We will provide access
13 to the retiree medical plan, but the non-union employees hired or rehired on or after January
14 1, 2014 will pay the full cost of premiums upon retirement. In addition, beginning January
15 1, 2020, the method for calculating health insurance premiums for non-union retirees under
16 age 65 and active Company employees will be revised. The revisions will result in separate
17 health insurance premium calculations for each group.

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

19 A. Yes, it does.