Ex. ______ (ALK-Testimony)
Docket Nos. UE-920433, UE-920499 and UE-921262
Witness: Andrea L. Kelly

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

PETITION OF PUGET SOUND POWER & LIGHT COMPANY FOR AN ORDER REGARDING THE ACCOUNTING TREATMENT OF RESIDENTIAL EXCHANGE BENEFITS	DOCKET NO. UE-920433
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	DOCKET NO. UE-920499
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	DOCKET NO. UE-921262

TESTIMONY

ANDREA L. KELLY

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

MAY 1993

Contents

ERRATA SHEET

1. Testimony of Andrea Kelly, Ex. T-___ (ALK-testimony)

Page 7, line 24:	insert "of administration and operations" after "control of costs."
Page 9, line 7:	insert "clear" before "relationship."
Page 9, line 18:	insert "on a per customer basis" after "fixed."
Page 9, line 24:	insert "currently" after "statistic."
Page 25, line 23:	insert "In the future," before "Employee."
Page 26, line 19:	line should read, "benefit to shareholders rather than to ratepayers. Finally"

2. Testimony of Patrick Moast, Ex. T-___ (PJM-testimony)

Page 10, line 11:	Change "October," to "October 1,"
Page 11, line 25:	Change "($18,215,800 w/.936 adjustment factor)." to "w/.936 adjustment factor."
Page 19, lines 18-19:	Place a period after "12/31/91." Delete "which is the period prior to the test year in this case."
Page 31, line 25:	After "Point 2," add "and participation in the 3rd AC Intertie,"

3. Exhibit of Patrick Moast, Ex. ___ (PJM-2)

Page 2:	Change units on the first line, both columns, from "kwh" to "kw."
Page 2:	Change units on the second line, both columns, from "mWh" to "mW."

4. Testimony of Kenneth L. Elgin, Ex. T-___ (KLE-testimony)

Page 11, line 11:	The word "one-half" should read "two-thirds."
Page 11, line 19:	The word "rate" should read "revenue."
Page 33, line 16:	"2.1" should read "2.01."
Page 34, line 10:	"588" should be "558."

Introduction

Q: What is your name and business address?

A: My name is Andrea L. Kelly. My business address is Chandler Plaza Building, 1300 South Evergreen Park Drive S.W., P.O. Box 47250, Olympia, Washington, 98504-7250.

Q: By whom are you employed and in what capacity?

A: I am employed by the Washington Utilities and Transportation Commission (Commission) as a Utilities Rate Research Specialist.

Q: Have you submitted an exhibit which summarizes your education and professional experience?

A: Yes. Exhibit ____ (ALK-1) provides such a summary.

Summary

Q: Please summarize your testimony.

A: I analyze the Company's testimony regarding its efforts at controlling costs of administration and operations functions as presented by Mr. Knutsen. I examine the areas where the Company has provided testimony with regard to cost control measures that are currently in place and with regard to specific actions that the Company has taken to reduce costs. Finally, I analyze the results of the recent organizational evaluation undertaken by Towers Perrin.

Based on my analysis, I conclude that the Company has not provided sufficient evidence to substantiate its claims of cost control over its administrative and operations expenses. I recommend that the Company's bonus expense associated with the Pay-at-risk program continue to be treated as a below-the-line expense and that the Company's bonus expense associated with the Energy Plus program be split, with 73.5% borne by the shareholder and 26.5% borne by the ratepayer. Additionally, prior to any allocation decisions, an adjustment should be made to both these programs to reflect the impact of goals that were not achieved, but for which the employees were compensated.

Q: What is the basis for your testimony?

A: My testimony is based on a thorough review of the data and information provided by the Company through testimony, deposition, and cross examination, as responses to data requests, and for inspection on the Company's premises through field audits.

Q: What evidence did the Company present with regard to cost effectiveness of administration and operations functions?

A: Mr. Knutsen's testimony focused on the following general areas:

- Results of Cost-Control Measures
- Company Efforts to Control Costs

I will examine each of these broad areas in turn. In addition, I will cite the testimony of other Company witnesses whenever relevant.

Results of Cost-Control Measures

Q: Could you please summarize the evidence on which the Company relies under the "Results of Cost-Control Measures" category?

A: In direct testimony, the Company presents a number of charts and graphs concerning what are described as "key elements of costs." Mr. Knutsen stated that on a per-customer basis these elements are as low or lower than they were a decade ago when the effects of inflation are removed. Mr. Knutsen further testified that these "statistics in my testimony, when taken together are evidence that we are controlling costs within the Company." (Deposition of Mr. Knutsen, Ex. 619, p. 10, ln. 19-21)

Q: What are the elements of costs that the Company analyzes?

A: Mr. Knutsen presents Exhibits 540 through 554, a series of charts and graphs concerning the following four areas:

A. Average annual residential bills

B. Total other Operation & Maintenance expense

C. Company employment levels

D. Salary and benefit expenses

A. <u>Average annual residential bills</u>

Q: Does the Company explain the significance of the average residential bill statistic?

A: Yes. Mr. Knutsen testified that the "results of our performance in achieving cost control show up in the bill the customer pays." (Ex. T-539, p. 3, ln. 11-12) In his testimony he states that the decline in bills seen from 1986-1991 is a result of two factors: "First, Company efforts in controlling costs played a significant part. Second, average use per customer has been going down." (Ex. T-539, p. 3, ln. 18-20) His Exhibit 541 graphs the average annual residential bill adjusted for inflation for the years 1981-1991.

Q: Are there any areas of concern relating to the Company's testimony regarding the decline in residential bills?
A: Yes. First, the time period that Mr. Knutsen uses as an example in his testimony is neither consistent with the rest of his testimony nor is it indicative of any overall trend. Second, the assumptions behind the Company's comparison of average annual residential bill figures are flawed.

Q: Could you please expand upon your first statement that the time period that Mr. Knutsen uses as an example in his testimony is neither consistent with the rest of his testimony nor indicative of any overall trend?
A: Throughout his testimony regarding what he defines as "key elements of costs", Mr. Knutsen consistently refers to a ten year period for comparison. (Ex. T-539, p. 2, ln. 23) However, for the residential bill statistic, he highlights the "five year period from 1986-1991." Incidentally, this period from 1986-1991 is six years, not five years.

Staff's analysis of the data presented by the Company in Exhibit 541 and in its response to Deposition Request 37 indicates that the average bill increase or decrease varies considerably depending on which time period is examined. For example, although inflation-adjusted annual residential bills have decreased by 16% from 1986-1991, from 1987-1991 average bills have decreased by only 7.7% of which 5.7% is directly attributable to a decline in use.

In addition, during the period from 1981-1991 to which Mr. Knutsen consistently refers elsewhere in his testimony, average annual residential bills have <u>increased</u> 22.3% on an inflation adjusted basis. During this same period, annual use per residential customer has <u>decreased</u> by 15.4%. Following the assumption used in the Company's comparisons that customer bills are impacted by only two factors (use per customer and Company efforts at controlling costs), this would indicate that Company costs have increased 37.7% on an inflation adjusted basis and have not stayed as low or lower, as the Company contends.

Finally, it must be noted that the Company's comparison did not include the years 1992 and 1993, a time of rate increases substantially in excess of inflation.

Q: Please discuss the limitations of the Company's comparison of residential bills across time periods.

A: The statistics presented in Exhibit 541 are adjusted for inflation but are not adjusted for the effects of weather or items such as resource acquisition that might significantly impact a certain time period. In addition, the relationship between residential bills and the Company's control of costs of administration and operations

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is not a direct one. Initially, any costs savings would be recognized in the form of improved earnings. Only through a general rate proceeding could any cost control measures be enjoyed by the ratepayers. As we see in this proceeding, these savings may be more than offset by other increases in the cost of doing business.

Just as an increase in residential bills may not be indicative of a lack of cost controls, a decrease does not prove that effective cost controls are in place. Indeed, Mr. Knutsen stated in response to questions during deposition that "in using any of these statistics one would have to examine what was going on during the period of time in question." (Deposition of Mr. Knutsen, Ex. 619, p. 13, ln. 25 - p. 14, ln. 1-2) Mr. Knutsen's testimony provides no explanation of "what was going on" during the different years. Therefore, the increases or decreases in average annual residential bills could be the result of circumstances not examined within the scope of Mr. Knutsen's testimony.

B. <u>Total Other O&M Expense per customer</u>

Q: The next statistic that the Company presents is "other O&M per customer", is that correct?

A: Yes. Mr. Knutsen's Exhibit 542 shows that on a per customer basis what he defines as "Total Other O&M" (which does not include power costs and conservation amortization) is about 2.5% less than in 1981 when adjusted for inflation.

Q: Are there any concerns regarding the Company's reliance on this statistic as evidence of cost control?

A: Yes. Staff's analysis shows no clear historical relationship between growth in customers and growth in the Total Other O&M Expense. My Exhibit ____ (ALK-2), based on data supplied by the Company, shows the annual growth in customers and the annual growth in Total Other O&M over the 1982-1991 time period. Although customer growth since 1981 has been fairly steady at 3% per year, the Total Other O&M expense has varied considerably.

One explanation for this may be that the costs that fall under the O&M category have different characteristics. While some may be truly variable on a per customer basis, others are fixed on a per customer basis and the addition of another customer may actually decrease the per customer cost. Still others may remain fixed over a certain range of customers, and then increase once outside of that range to form a step-like pattern, if they were graphed.

While it is valuable for the Company to monitor Total Other O&M on a per customer basis, this statistic currently does not provide a complete picture and does not provide evidence of cost control. Over the past ten years, the Total Other O&M expense has increased by 33%, an average of 3.3% per year. However, this statistic is just an average. From 1990 to 1991, Total Other O&M increased by approximately $14 million, or 8%; this is over 2.4 times the annual average. Customer growth during that time period was approximately 3%. Conversely, from 1989 to 1990 Total Other O&M <u>decreased</u> by 5.7%, as the number of customers grew by 4%. These types of swings seen consistently through the past ten years provide no basis for a conclusion that the Company has effective cost control over its Total Other O&M expense.

C. <u>Company Employment Levels</u>

Q: What evidence did the Company present with regard to Company employment levels?

A: The Company presented two charts. The first, Exhibit 543, shows the trend in employees per 1000 customers for the Company from the years 1981-1991. The second, Exhibit 544, compares the Company's 1991 employees per 1000 customers statistic with four neighboring utilities. I will discuss each separately.

Q: Are there any problems with relying on the employees per customer statistic as evidence of cost controls?

A: Yes. Once again, it is valuable for the Company to monitor this statistic and to use it as a planning tool. However, there are two major concerns regarding the Company's reliance on this statistic as evidence of cost control. First, Staff's analysis indicates no historical relationship between the change in number of customers and the change in number of employees. Second, the use of contract labor is not reflected in this statistic although it is playing an increasingly significant role in the Company's overall labor strategy.

Q: Could you explain the first concern regarding the lack of a historical relationship between the change in number of customers and the change in number of employees?

A: Yes. Exhibit _____ (ALK-3) is a graph of the annual percent change in customers and the annual percent change in employees from 1982-1992. As I have previously noted, annual customer growth has remained fairly stable at 3% since 1982. However, employee growth has not followed a similar pattern.

Mr. Knutsen has stated that "we do things in the Company to try to intentionally have this occur, have the number of employees go down in relation to the number of customers we serve." (Deposition of Mr. Knutsen, Ex. 619, p. 15 ln. 25, p. 16 ln. 1-3) The graph in Exhibit ____ (ALK-3) indicates otherwise.

As this exhibit shows, from 1982 through 1990, growth in employees had been, to a varying degree, less than the growth in number of customers. However, since 1990, growth in customers has begun to decline while growth in employees has reached its highest levels and actually exceeded the customer growth figures. Growth in employees in excess of the growth in customers is the opposite of what the Company has testified it is trying to achieve. (Tr. 1240, ln. 10-12)

Q: Mr. Knutsen testified that recent higher growth in employees per 1000 customers does not mean that the Company has failed to control costs. (Tr. 1239) Do you agree?

A: Yes, the need for growth in or for downsizing of the Company's workforce is influenced by various factors, only <u>one</u> of which is growth in customers. This leads me to a second concern.

Q: This second concern that you expressed has to do with the Company's increasing use of contract labor. Could you explain this concern?

A: Yes. The Company's use of contract labor is another factor that can impact the employee per customer statistic. Mr. Knutsen has testified that the Company uses contract labor for a variety of reasons: to manage peaks and valleys in the workload, to handle work outside of the Company's areas of expertise, and to mend damage caused by storms. (Tr. 1252-1254)

Management's decision to use contract labor is presumably based on cost and practicability considerations that can change over time. For example, in recent years the Company has changed its construction practices from having its service centers do all the work to hiring contract crews. (Tr. 1254, ln. 14-21) This type of change reduces the need for employees but increases the need for contract labor. The Company's Exhibit 543 shows only one side of this shift.

As Exhibit ____ (ALK-4) shows, the use of contract labor has increased dramatically from $19 million in 1986 to $52 million in 1992. If these numbers were adjusted for inflation using the adjusters given by Mr. Knutsen in deposition, the Company's contract labor expense would double from approximately $23 million in 1986 to approximately $46 million in 1991. (Deposition of Mr. Knutsen, Ex. 619, p. 12, ln. 2-5) However, this increase in contract labor does not coincide with a corresponding decrease in employees. During 1991 and 1992, when the employee per customer ratio was growing, the Company also increased its use of contract labor.

The employee per customer statistic alone provides an incomplete picture of the Company's overall labor force. Because of this and the lack of any clear historical relationship between growth in employees and growth in customers, this statistic currently provides insufficient evidence as to whether the Company is controlling costs.

Q: With those concerns in mind, could you please discuss the comparison shown in Exhibit 544, comparing Puget with other neighboring utilities?

A: By Mr. Knutsen's own admission, "any of these intercompany comparisons are tricky." (Deposition of Mr. Knutsen, Ex. 619, p.17, ln. 17) Employment needs vary depending on a myriad of factors that are inconsistent between utilities.

A few examples are:

- percent of power that is purchased vs. generated
- customers per square mile
- use of contract labor and outsourcing
- type of power generation
- metropolitan vs. rural service territory

These factors combine to make it very difficult to compare the proverbial "apples to apples", thus diminishing the ability to draw conclusions from a chart like the one presented in Exhibit 544.

D. <u>Salary and benefits expenses</u>

Q: The fourth area in which the Company presented testimony on cost control in administration and operations involved the trends in employee salary and benefits expenses. Is that correct?

A: Yes. The Company presented several exhibits that indicate on an inflation-adjusted basis employee salaries and benefits are lower per employee than they were in 1981.

Q: What has analysis revealed about the average employee pay statistic?

A: On the surface, it appears that the Company has maintained a fairly stable average employee pay when adjusted for inflation. However, two factors raise questions about whether this indicates cost control.

Pages 1 and 2 of Exhibit ____(ALK-5) show an excerpt from a report comparing Puget and other utilities regarding certain utility operating statistics. As explained on page 1 of this exhibit, Puget is represented by the dotted horizontal line. The median for the comparison group is represented by the horizontal line inside the narrow box. The comparison indicates that the Company's average annual wage per employee is above the median when compared with other utilities nationwide. Also, the charts shown on pages 3 & 4 of the same exhibit indicate that the Company's overtime expenditures not related to storm damage have increased dramatically since 1990.

Q: What has analysis of the benefits per employee expense revealed?

A: This is an area where there is compelling evidence that the Company has been successful in its recent cost control efforts. As Mr. Knutsen's testimony indicates, the Company has effectively reduced the costs of benefits on a per employee basis since 1981. (Ex. 539, p. 5, ln. 19-20) As Exhibit____ (ALK-5), page 2 shows, the Company's costs for benefits per employee are also well below the median when compared with other utilities. Finally, results from Puget's 1990 Employee Opinion Survey and recent Employee Focus Groups did not indicate any employee dissatisfaction with the benefits package. This evidence indicates that the Company's efforts at controlling its cost of benefits have been successful.

E. Summary

Q: Could you please summarize your testimony regarding the statistics presented by Mr. Knutsen in the section of Exhibit T-539 entitled "Results of Cost-Control Measures"?

A: Mr. Knutsen has testified that no one statistic can be used as evidence of cost controls but that the statistics he presented together provide evidence that the Company has been effective at controlling costs of administration and operations. (Deposition of Mr. Knutsen, Ex. 619, p. 10, ln. 19-21)

I agree with Mr. Knutsen that no one statistic can prove that the Company has control over costs. However, each statistic must hold up under scrutiny in order to collectively provide testimony to the evidence of cost controls. Staff's analysis and research raises serious concerns about three of the statistics upon which Mr. Knutsen relies.

For the various reasons that I have previously discussed, the statistics upon which Mr. Knutsen relies do not provide sufficient evidence regarding the Company's ability to control costs. This is not to say that the Company has not controlled costs. Rather, the statistics presented are insufficient for a conclusion either way.

Company Efforts to Control Costs

Q: On what evidence does Mr. Knutsen rely in the section of Exhibit T-539 entitled "Company Efforts to Control Costs"?

A: Mr. Knutsen's testimony describes two specific areas of cost control. The first is what he calls "Cost Control-Based Employee Compensation". The second is entitled "Periodic Organizational Effectiveness Evaluations". Mr. Knutsen also presents a section focused on specific programs that the Company has undertaken to reduce costs.

A. <u>Cost Control-Based Employee Compensation</u>

Q: Could you please summarize the Company's testimony regarding cost control-based employee compensation?

A: Mr. Knutsen highlights three compensation programs that he characterizes as cost control-based; Ideas Plus, Energy

Plus, and Pay-at-risk. I will examine each of these separately.

Q: Could you briefly explain the Ideas Plus program?

A: Yes. The Ideas Plus program is an employee suggestion program aimed at identifying and implementing ways for the Company to conduct business in a more cost-effective manner. Employees receive 10% of tangible first year savings up to $10,000 for any idea that can be implemented within two years.

Q: Does the evidence provided by the Company indicate that this is a successful cost control-based program?

A: Yes. From a cost-saving perspective, the evidence indicates that the Ideas Plus program has been very successful. Since the program's inception in 1985 through 1991, employee ideas have led to $3.4 million in first-year tangible savings. Payouts to employees during this time period were $230,000. (Ex. 551) Clearly, a net benefit to the Company.

Additionally, the 1990 Employee Opinion Survey indicates that only 16% of survey respondents expressed dissatisfaction with the Ideas Plus program. (Company response to Staff Data Request 2459, p. 55) Employee perception of the program is a key to its success or failure; if employees view Ideas Plus unfavorably, they will be less inclined to participate.

Q: Could you now briefly explain the Energy Plus program?

A: Yes, the Energy Plus program is a bonus program for all employees below the department head level. It has been in place since 1987 and is designed so that employees will receive a payout if certain goals are accomplished.

Q: Does the evidence provided by the Company indicate that this is a successful cost-based compensation program?

A: No. Staff's research into this program has uncovered several areas of concern. First, the program's goals are more oriented toward service than toward cost control. Second, the payout for the year 1991 was based on the achievement of a goal that was not, in fact, achieved. Third, a key element of the program is an Earnings per Share target. Finally, the program provides more benefit to the shareholder than it does to the ratepayer.

Q: Please discuss the first concern that the goals of the program are more oriented toward service than toward cost-control.

A: Although Mr. Knutsen discussed this program under the heading of "Cost Control-Based Compensation", the majority of the goals that he has listed in his Exhibit 550 are service oriented rather than cost control based. Indeed, as shown in my Exhibit ____ (ALK-6), since 1987 the Company has paid out $11.85 million and has achieved quantifiable savings of only $8.54 million, a $3.3 million deficit for this program. In addition, although the program was initially intended to fund itself out of the realized savings, the Company began to budget for the entire payout in 1993. (Tr. 1264-1265)

Q: Staff's second concern is that the 1991 Energy Plus payout was based on the achievement of a goal that was not actually achieved. Is that correct?

A: Yes. As Mr. Knutsen has verified, in 1991 the $800 per employee payout was calculated as if the Company had reached the O&M Energy Plus Budget target. In reality, the Company had come in over-budget and therefore did not achieve this target. (Tr. 1273, ln. 11-22)

As the Company explained, the decision to overlook this non-achievement was made by senior management. They felt that certain expenditures that were authorized by management in the fourth quarter of 1991 had caused the Company to come in over-budget. They further rationalized that their employees should not be penalized for management's decisions. (Tr. 1274, ln. 5-14) However, in effect, management was instead penalizing the ratepayers by seeking reimbursement of expenses for results that failed to meet the well-defined goal.

Management's decision resulted in an increase of the Energy Plus payout from $600/employee to $800/employee. (Tr. 1276, ln. 16-21) Since a portion of this expense is included in test year figures, Staff recommends that the test year Energy Plus expense for 1991 be decreased by 25% to reflect actual achievement of Energy Plus targets. Mr. Nguyen's testimony will show the calculation of this adjustment.

Q: What are Staff's concerns about the goal that targets Earnings per Share?

A: Since 1990, the Energy Plus payout has been contingent on two equally important factors; achievement of an Earnings per Share (EPS) target and achievement of at least five of the Energy Plus targets shown in Mr. Knutsen's Exhibits 549 and 550. However, despite the fact that the EPS target is an established element of the Energy Plus program, in pre-filed testimony and in the original and revised Exhibits 549 and 550, <u>there is no mention of the EPS target</u>. The omission of this information provided an incomplete picture of the overall goals of the Energy Plus program.

Internal company targets directed at earnings per share motivate employees in a way that benefits shareholders. As the Company explained in its 1990 Energy Plus program description:

> "This year the change (in the Energy Plus program) is more significant: the introduction of an overall corporate financial 'health' measure - earnings per share (EPS). It only makes sense that before we pay ourselves, we should first pay the owners of our company, the shareholders (and, of course, most of us are shareholders, too). This tie to company performance changes Energy Plus from a goal-sharing program to a true gain-sharing program. Real, measurable gains--represented by the EPS threshold--must be realized before payouts are made."

Even though the nature of the Energy Plus program has clearly changed to what the Company characterizes as a "gain-sharing program" with shareholders, the Company still proposes that ratepayers bear the burden of the entire Energy Plus expense. This leads to Staff's third concern.

Q: Could you explain Staff's concern that the Energy Plus program motivates employee behavior which is more beneficial to the shareholder than to the ratepayer?

A: Staff believes that it is not fair, just, and reasonable for ratepayers to bear the entire expense of an employee incentive program with goals oriented toward earnings and profitability. Expenses that are a result of achieving an earnings threshold become circular in a rate case setting.

Exhibit ____(ALK-7) examines the goals of the Energy Plus program that were achieved in 1991 and 1992 and that are in place for 1993. Staff examined who benefits from each goal and developed three categories; shareholders, ratepayers, and both.

Based on Staff's assessment, the corresponding percentages were assigned. In cases where both were seen to benefit, the burden was shared equally. For the targets called Community Service and Environmental, although I recognize the overall societal value these provide, I have been advised by counsel that based on the decision in Jewell v. WUTC, 90 Wn.2d 775 (1978), the shareholder is to bear the costs associated with the Company's charitable endeavors and image building. Exhibit____ (ALK-8) is an excerpt from the Company's 1993 Energy Plus Brochure. The activities represented by the Community Service and Environmental targets are shown on pages 3 and 4 of the exhibit or pages 14 through 16 of the brochure. I have allocated these two targets 100% to shareholders.

Staff's analysis indicates that shareholders on average receive 73.5% of the benefit from the goals of the Energy Plus program while ratepayers receive 26.5%. Staff therefore proposes that the test year Energy Plus expense be adjusted to reflect a 73.5/26.5% split between shareholders and ratepayers. Mr. Nguyen's testimony will show the calculation of this adjustment.

Q: Does Staff have an additional concern regarding the Conservation target for the Energy Plus program?

A: Yes. Pages 1 and 2 of Exhibit ____ (ALK-8), pages 9 through 11 of the brochure, describe the energy conservation goal. Company employees can earn points toward the Conservation goal by performing energy conservation at home, by referring customers to the conservation programs, and by implementing conservation measures in Company facilities.

Staff is concerned that the bonuses that come as a result of achieving this target are not reflected in the Company's costs of the conservation resource. In the future, Employee compensation incentives related to conservation should be reflected as a cost of that resource for planning purposes.

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Q: The third cost control-based employee compensation program discussed by Mr. Knutsen is the Pay-at-Risk program. Please discuss this program.

A: The Pay-at-Risk program covers approximately 50 employees who are department heads and officers of the Company. Achievement of the program's goals allows these employees to receive between 10% and 35% of their base salary as a bonus. In 1992, the at-risk payout was $752,900, an average of $15,058 per employee. Mr. Knutsen has agreed that "pay-at-risk" is termed "bonus" by other companies. (Deposition of Mr. Knutsen, Ex. 619, p. 44, ln. 24-25, p. 45 ln. 1)

Q: Does Staff have any concerns about the Pay-at-risk program?

A: Yes. Staff research has revealed several areas of concern. First, these bonuses have historically been recorded below the line and the Company has presented no evidence as to why these should now be treated any differently. Second, the nature of the goals, which are earnings oriented, provides more benefit to shareholders rather than to ratepayers. Finally, the goals were manipulated at the end of the year in 1991 and 1992, which increased the overall payout amount.

Q: Could you please discuss Staff's first concern with the change in treatment of the Pay-at-Risk expense?

A: Yes. Since the program's inception in 1985, this expense has been consistently treated as a below-the-line expense. However, the Company has brought this expense above the line for this general rate case. The rationale behind this change was not addressed by any Company witness in pre-filed direct or supplemental testimony or in the initial depositions. It was not until the Company's last witness in cross examination, Mr. Story, that this change was brought to light. (Deposition of Mr. Story, Ex. 634, p. 94-95, ln. 17-24)

Mr. Story mentioned that he believed Mr. Sonstelie had addressed this issue. However, Staff's review of transcripts revealed no such discussion. Even though Mr. Knutsen presents the Pay-at-risk program in his testimony and was questioned on it in deposition and cross, he also made no mention of the change.

Q: Does Mr. Story provide some explanation for bringing this expense above the line?

A: Yes. Mr. Story stated that the salaries of the employees under this program are set at a lower than market rate. He stated that if the goals are not met then the employee would not earn the equivalent of 100% of his or her salary. (Deposition of Mr. Story, Ex. 634, p. 95, ln 1-5) However, the Company has presented no data to support these claims.

Referring back to pages 1 & 2 of Exhibit ____(ALK-5), the graph in the top right corner indicates that average salaries at the Company are above the median when compared with other utilities. Even if the bonuses were subtracted from the data in this chart, the average Company salary would still exceed the median.

Assuming Mr. Story's rationale would justify recovery of bonuses from ratepayers, the Company has failed to justify ratepayer responsibility for such bonuses. Therefore, Staff recommends that the Pay-at-Risk expense continue to be treated as it has been since 1985, below the line. Mr. Nguyen's testimony will show the calculation of this adjustment to test year figures.

Q: Staff's second concern involves the nature of the goals of the Pay-at-Risk program. Could you please explain this concern?

A: Yes. As shown in the Company response to Record Requisition 527, in 1991 the primary Pay-at-Risk goal was a range of EPS targets. The secondary goals were Market-to-Book ratio, weighted 60%, Bond Rating, weighted 20%, and Energy Plus, weighted 20%. In 1992, the primary goal was still an EPS target. However, the secondary goals were modified to equally consider Conservation, Energy Plus, and Efficiency Performance factors. With EPS as the driving factor in this program, Staff has the same concerns about the Pay-at-Risk program as the Energy Plus. It serves to benefit the shareholders, yet the Company wants the ratepayers to bear the expense.

Q: The final concern that you mentioned involved manipulation of the goals by the Company at year end. Could you please explain this concern?

A: Yes. Staff is concerned that the payouts under this program are at the whim of the Company. Both in 1991 and 1992, the predetermined goals were modified and relaxed at year end; these were decisions that increased the level of bonuses.

As I have previously discussed, in 1991 the Company did not achieve its O&M Energy Plus Budget target. This non-achievement also impacts the Pay-at-Risk amount. As discussed in the Company's response to Record Requisition 528, even though the O&M budget was not met, and even though the articulated reason given for not meeting it was decisions made by senior management, the Board of Directors decided to pay the senior managers <u>as if the goal had been</u>

met. This decision increased the overall payout by 3% or approximately $25,000.

Apparently, the Board of Directors rationalized that the Company was within .5% of the budget and found that acceptable. However, the goal is very clearly stated that the Company must "**operate within total Company O&M budget**", not "within .5%". Although it is certainly within the Board's discretion to award bonuses as it sees fit, it does not seem fair, just, or reasonable for ratepayers to bear the burden of that generosity.

Similarly, as shown in the Company's response to Record Requisition 530, adjustments were made to the secondary modifiers at year end 1992. Mr. Knutsen explains in the response that "year-end adjustments were made to these tables to account for both unexpected expenses and budgeting errors." These year-end adjustments increased the overall payout by 9.5% or approximately $72,000. If recovery of the Pay-at-risk program were to be allowed, it would be necessary to deduct this $72,000 from the test year figure.

Finally, Staff believes that it is important to note that the goals for the 1993 Pay-at-Risk program have yet to be set. With over one quarter of the year elapsed and still no goals, one must question whether there is an effective Pay-at-Risk program in place for 1993.

B. Periodic Organizational Effectiveness Evaluations

Q: Could you please summarize the Company's testimony regarding periodic organizational effectiveness evaluations?

A: Mr. Knutsen listed several effectiveness reviews that the Company undertook during the 1980's. He also discussed the work that recently has been undertaken by the consulting firm of Towers Perrin.

Q: What has Staff's analysis revealed about these periodic organizational effectiveness reviews?

A: Staff believes that it is valuable for the Company to conduct reviews of the organization on an ongoing basis. One concern that Staff has is with the Company's follow-through after the evaluation has been conducted and recommendations have been made.

In 1989, the Company undertook a General Office Value Analysis which examined corporate support services. However, the Company did not conduct any discrete analysis after the fact to assess the effectiveness of the evaluation. (Deposition of Mr. Knutsen, Ex. 619, p. 47, ln. 9-12) Subsequently, Towers Perrin identified corporate support services again as an area for improvement within the Company.

In 1989, the Company formed a Division Task Force to evaluate division services. This evaluation led to a restructuring that was intended to "get everybody as close to our customers as we could and in doing so eliminate a layer of management." (Deposition of Mr. Swofford, Ex. 609, p. 12, ln. 22-24)

As the Company's response to Deposition Request 29 indicates, this elimination of a layer of management resulted in a company-wide reduction in 1990 of only three supervisory employees. Mr. Knutsen has testified that this division restructuring is an ongoing process. However, between December of 1989 and December of 1992 supervisory employees have <u>increased</u> by 18%. Non-supervisory employees have increased by only 10% during that time period. This would indicate that the goal to "get everybody as close to our customers as we could" has been difficult for the Company to achieve.

Q: Has Staff reviewed the recommendations from the evaluation conducted by Towers Perrin?

A: Yes. Two consultants from Towers Perrin recently presented the findings of their evaluation to the Commission Staff. Although there has not been sufficient time to conduct a thorough review of the basis for the recommendations, Staff can offer preliminary reactions to the presentation and the recommendations.

The consultants were impressed with the Company's commitment to the integrity of the evaluation. The Company stressed to them that it was primarily interested in the identification of areas for improvement rather than areas of strength. The Company also committed substantial financial and human resources to this effort. Towers Perrin was allowed to select the members of the Company team. This Company team worked together with Towers Perrin to complete the evaluation and to formulate the recommendations. The recommendations were divided into three categories:

1. Potential for Near-Term Gain with Some Risk: refers to implementation timing within the next six to eighteen months. The five recommendations included: selective reduction of the Company's investment in fleet assets, reduction of the Transmission & Distribution inventory investment, selective centralization of Company business offices functions, utilization of a multi-year horizon for capital budgeting, and reduction of administrative costs of the Company's employee benefits programs. These recommendations could result in an estimated annual savings of between $1.605 million and $3.696 million.

2. <u>Potential for Medium-Term Gain with Significant Risk</u>: refers to implementation timing within the next 18 to 24 months. The eight recommendations explored ways for the Company to: 1) strengthen Permit and Licensing roles, responsibilities, and management processes, 2) increase engineering effectiveness, 3) upgrade management processes of construction of T&D capital projects, 4) improve materials management operations, 5) reduce costs of employee benefits, 6) reduce costs of IS (information services) while offering higher value, 7) selectively scale back external relations and graphics support, and 8) control and monitor legal costs. Towers Perrin would not release estimates for cost savings related to these proposals because of concerns that any estimate would be speculative.

3. <u>Potential for Long-Term Gain but not Without Further Study</u>: refers to an implementation timing that has not been established. The proposals encouraged the Company to examine: 1) the optimal balance between cost and quality of service as it relates to the Company's business offices, 2) a longer-term planning horizon to contribute to more optimal decision-making, and 3) Company conservation efforts in relation to its Least Cost Plan. Once again, estimates of potential cost savings were deemed premature.

Q: Has the Company given any indication of its intentions to implement these recommendations?

A: Recent announcements in the press indicate that the Company has already begun to implement a cost-cutting campaign as a result of the work of Towers Perrin. However, since this is an ongoing process, Staff recommends that the Commission take advantage of the Company's offer to provide a periodic report of its efforts and accomplishments.

C. <u>Specific Programs to Reduce Costs</u>

Q: Could you please summarize the Company's testimony regarding specific programs to reduce costs?

A: Mr. Knutsen highlighted three specific programs where Company efforts have been successful in reducing costs. These programs targeted 1) health care costs, 2) credit and collection costs, and 3) efficiency of customer telephone functions.

Q: Has Staff's research uncovered any other areas that might benefit from the same type of scrutiny that these areas received?

A: Yes. Staff believes that it might be beneficial for the Company to more closely examine three separate areas; 1) the

Achieving Extraordinary Customer Service Program, 2) the customer outreach programs identified by Mr. Swofford on pages 17 through 19 of Exhibit T-535, and 3) the Vegetation Management Program.

Q: Why does Staff believe that the Achieving Extraordinary Customer Service warrants closer scrutiny by the Company?

A: The evidence presented by the Company indicates that this is a program that began in 1992 and is a "must training for all customer contact personnel." (Ex. T-535, p. 20, ln. 15-19) The Company's response to Staff Data Request 2484 shows that this program has cost the Company nearly $185,000 over the past two years. Mr. Swofford testified that this program caused the 1992 training costs per full-time equivalent to rise to $1115 when the budgeted amount for training was $427 per full-time equivalent. (Tr. 1151, p. 9-20)

Customer Perception Surveys conducted by the Company indicate that in 1992, 90% of customers had a favorable perception of the Company. This was up only 1% from 89% in 1991. In addition, Exhibit 550 indicates that the Company has <u>always</u> achieved its Energy Plus target of Customer Perception since the Energy Plus program began. Indeed, this is the only target that the Company has achieved in all six years of the program.

This raises the question of whether an increase in training expenses by two and a half times is necessary in an area where the Company is clearly very strong.

Q: Why does Staff believe that the customer outreach programs discussed by Mr. Swofford deserve closer examination?

A: In Exhibit T-535, Mr. Swofford lists a number of customer outreach programs. These include the consumer panels, the customer advisory committees, the energy fund, the language bank, the gatekeeper program, and the speaker's bureau program. While Staff recognizes that these programs may provide valuable services to the customers of Puget, Staff is concerned because the Company does not track the costs associated with these programs. Since the costs are not tracked, there is no way to monitor what these programs are costing the ratepayer and whether current levels of expenditures are warranted.

Q: Does Staff have similar concerns regarding the Vegetation Management program?

A: Yes. Staff is again concerned that the Company is not closely monitoring the costs of this program. The Company's response to Data Request 2354 indicated that the contract labor expense for this program exceeded its budget by nearly

$500,000 in both 1991 and 1992. However, when Mr. Swofford was asked to explain the reason for this, he could offer no explanation. (Tr. 1167, ln. 11-13)

The Vegetation Management program is managed by a corporate forester. The corporate forester reports directly to the director of division services. Mr. Swofford is the Vice President of Corporate and Division Services. It seems reasonable to expect that he would have knowledge of why contract labor for this program exceeded the budget by $500,000 for two years in a row.

Q: Could you summarize Staff's recommendations regarding these three programs?

A: Yes. Staff believes that both the Company and the ratepayers could benefit from an ongoing assessment of the costs and benefits associated with these particular programs. The Company should be held accountable for these programs. Staff therefore recommends that the Company implement a method of tracking and monitoring these costs that ensure cost-effectiveness and value to the ratepayer.

Q: Does that conclude your testimony?

A: Yes, it does.