

EXHIBIT NO. _____ (MKG-1T)
DOCKET NO. _____
2001 PSE RATE CASE
WITNESS: MARK K. GORDON

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

**DIRECT TESTIMONY OF MARK K. GORDON
ON BEHALF OF PUGET SOUND ENERGY, INC.**

NOVEMBER 26, 2001

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

PUGET SOUND ENERGY, INC.

DIRECT TESTIMONY OF MARK K. GORDON

I. INTRODUCTION

Q: Please state your name, business address and position.

A: My name is Mark K. Gordon. My business address is One Embarcadero Center, Suite 1400, San Francisco, CA 94111-3703. I am a principal at Hewitt Associates LLC ("Hewitt").

Q: Would you describe your educational background, employment experience and current responsibilities?

A: My responsibilities and educational and employment experience are described in Exhibit MKG-2.

Q: What is the purpose of your testimony?

A: The purpose of my testimony is:

- To explain the purpose, prevalence, costs and effectiveness of variable incentive pay in industry generally, and specifically at Puget Sound Energy, Inc. ("PSE").
- To explain how variable and incentive pay is designed to affect employee motivation, customer service, costs, efficiency and ultimately ratepayers.

Q: Would you please summarize your testimony?

A: Broad-based variable pay plans are used in over 80% of organizations today because the benefits (or performance outcomes) outweigh the program costs. They have taken on increasing importance in helping utilities provide a competitive "total compensation" package that allows them to compete with general industry companies to attract and retain a competent, stable workforce,

1 minimizing costs associated with high turnover, including recruiting, training, and
2 "downtime." Variable incentive compensation helps ratepayers by managing the
3 company's ongoing costs, as incentive awards must be "re-earned" every year as
4 opposed to "fixed" base pay which becomes an ever increasing entitlement
5 without any requirement for improved operating performance. Variable
6 compensation can also benefit ratepayers by increasing levels of customer service,
7 reliability, and the like, if designed to provide incentives for such improved
8 efficiencies and benefits. PSE's employee incentive plan design is consistent with
9 market practices and benefits ratepayers by creating employee incentives to
10 control costs and increase efficiency, productivity, service and safety.

11 II. VARIABLE INCENTIVE PAY IN INDUSTRY

12 **Q: Would you give an overview of the current role of variable incentive pay in**
13 **American business?**

14 A: Corporate America, including the utility and energy services industry, has
15 undergone significant changes and restructuring over the past decade. Evolving
16 business strategies, global competition, workforce demographics, and the
17 competitive labor market are key factors driving companies to create flexible
18 organization structures and human resource systems necessary for ongoing
19 business success. One of the more subtle but sweeping changes in human
20 resource strategy over this time period has been the widespread implementation of
21 variable incentive compensation programs as an integral element of the total
22 compensation and performance management systems. Increasingly, these
23 systems, once reserved for senior management, are being extended to cover all
24 employees.

25 A properly designed incentive program with a competitive award structure
26 has become a critical strategy for retaining employees, recruiting new talent and

1 motivating desired performance. A company without an incentive compensation
2 program today is at a competitive disadvantage.

3 **Q: What are the reasons behind the use of variable incentive pay?**

4 A: The philosophy and strategic reasons behind the introduction of variable incentive
5 plans include:

- 6 • Linking pay with performance and personal contribution to results.
- 7 • Motivating participants to achieve higher levels of performance.
- 8 • Communicating and focusing on critical success measures.
- 9 • Reducing fixed costs including the direct, ongoing build-up of base salary
10 and indirect costs of pay-related benefit programs (i.e., life insurance, time
11 off, etc.).
- 12 • Reinforcing desired behaviors, as well as results.
- 13 • Reinforcing an employee ownership culture.

14 **Q: What factors in an incentive pay plan affect whether the program will be**
15 **effective?**

16 A: While the majority of companies administer variable incentive programs, not all
17 have been successful in changing behavior or improving performance results.

18 Factors that increase the rate of success include:

- 19 • Setting realistic goals or targets.
- 20 • Effectively communicating plans.
- 21 • Using appropriate measures and tracking methods to measure progress.
- 22 • Ensuring a clear understanding of plan objectives.

23 In addition, motivation theory suggests that the effectiveness of an incentive plan
24 must be driven by the employee's perception of the ability to impact performance
25 results, the probability of achieving pre-set goals and the meaningfulness of
26 rewards.

1 **Q: What proportion of U.S. businesses, including energy services and utility**
2 **companies, have variable incentive pay plans?**

3 A: A recent Hewitt survey (2001/2002 Salary Increase Survey) of over 900
4 manufacturing and service companies (including 47 gas and electric utilities)
5 shows that the prevalence of U.S. companies with at least one broad-based
6 variable compensation plan has increased from 51% in 1991 to over 80% in 2001.
7 The prevalence among utility organizations is consistent with the broader survey
8 group. Since 1991, average company spending (as a percent of payroll) on broad-
9 based variable pay for salaried exempt employees (below the executive level) has
10 steadily increased over 250% from 3.8% to 10.8% of payroll. This has shifted pay
11 from fixed base pay to variable pay, which is more closely tied to desired results.
12 Over the same time period, average annual merit increase budgets have declined
13 from 5% of payroll to between 4.0% and 4.5%. This inverse relationship
14 demonstrates the increasing role variable pay has played in the total compensation
15 mix shifting from "fixed pay" to "at risk" target pay for performance.

16 This trend is expected to continue in the foreseeable future as
17 organizations continue to differentiate, recognize, and reward performance results
18 year to year at the corporate, business unit, and individual levels.

19 **III. PSE'S VARIABLE INCENTIVE PAY PLANS**

20 **Q: Have you reviewed PSE's variable incentive pay plans?**

21 A: Yes.

22 **Q: On what basis did you formulate your analysis of PSE's plans?**

23 A: I have reviewed and analyzed each of PSE's current incentive pay plans. The
24 analysis is based on Hewitt's collective resources and my knowledge and
25 experience gained in consulting with numerous organizations including many
26 utilities and energy services companies.

1 **Q: What purposes are designed to be achieved by PSE's incentive plans?**

2 A: PSE's incentive plans are intended to improve PSE's collective performance by
3 helping employees focus on selected goals, motivating them to change their
4 behaviors and rewarding them for performance achievement. PSE's broad-based
5 incentive program is called the Goals and Incentives program because it combines
6 identification of key goals and provides a monetary incentive when these goals are
7 accomplished. All employees participate in the plan from bargaining unit to the
8 officer level. PSE's Goals and Incentives program is designed to communicate to
9 employees specific, attainable yet challenging goals. PSE has defined key
10 business goals to include improving employee productivity, operational
11 efficiency, safety and customer satisfaction. The incentive program is an integral
12 part of an overall business strategy that PSE has adopted to be the "Best
13 Distribution Company" in the energy services industry, as measured by quality
14 customer service and low costs to customers.

15 **Q: Would you please explain how the incentive goals are established for PSE**
16 **employees?**

17 A: Employees are encouraged to propose goals each year to PSE's management.
18 Goals must be measurable, results-oriented, and clearly stated so employees have
19 a clear "line-of-sight" for how their personal work affects whether a particular
20 goal was achieved. After being developed by employees and proposed to their
21 managers and supervisors, goals are reviewed and edited by directors, and then
22 submitted to the Company's officers for final selection and development.

23 Employee groups are then assigned specific goals, including goals
24 contributing to efficiency, safety, customer service and cost control. The
25 employee group assigned to a particular goal then determines how to go about
26 achieving the goal and develops an implementation plan.

1 **Q: Would you describe the incentive award goals that apply generally to PSE**
2 **employees?**

3 A: Each employee has a combination of corporate, business unit and team goals,
4 which are weighted based on organization level and job function. All employee
5 incentive awards are tied in part to the successful achievement of the ten Service
6 Quality Indices ("SQIs") established with the Commission and to the cost-
7 effective operation of the Company.

8 As an example, PSE's goals include electric and gas emergency response
9 metrics, targeted outage reductions and a variety of customer service metrics such
10 as IT service levels, customer billings and call center performance, all of which
11 are related to broader Company SQIs. The goals are designed so that cost
12 containment initiatives cannot be achieved by compromising customer service and
13 reliability. The final awards for financial goals are reduced 10% for each of the
14 ten SQI goals established with the WUTC that are not met. For example, if only
15 six of the ten SQIs are achieved, any payout of the corporate and business unit
16 financial goals would be reduced by 40%. PSE sets threshold, target and superior
17 levels of performance goals that are tough, but achievable. To motivate this level
18 of operating performance, PSE provides meaningful award opportunities at
19 competitive market levels and "upside" opportunities for superior performance
20 levels.

21 **Q: How do incentives apply for PSE employees who are subject to collective**
22 **bargaining agreements?**

23 A: All employees at PSE are eligible to participate in the Goals and Incentives
24 program. Employees subject to collective bargaining agreements have a similar
25 set of objectives as other non-exempt and exempt employees who are not covered
26 by bargaining agreements. The primary difference for represented employees is

1 that the target award opportunities are expressed as a fixed dollar amount and are
2 equal for all members of a bargaining group. Non-represented employees have
3 their target awards expressed as a percentage of base pay. Otherwise, the
4 administration of the program is the same for all employees.

5 **Q: How is PSE's incentive plan at the officer and director level structured?**

6 A: Officers and directors participate in the same program as all other employees. At
7 this level, a higher portion of incentives is weighted based on earnings per share
8 results. However, the “funded award” based on earnings per share is reduced 10%
9 for each of the ten SQI goals established with the WUTC that are not met. This
10 balanced structure emphasizes the need both for financial success and for
11 delivering operating results that are in the customers’ interest.

12 **Q: How does PSE's plan compare with other companies in the industry?**

13 A: PSE's Goals and Incentive program is more detailed in the specificity of financial
14 and non-financial goals and better communicates the linkage of goal attainment
15 with incentive award opportunity than the majority of broad-based incentive plans
16 at other companies. Very often, broad-based incentive plans are solely tied to
17 company earnings with no variation for business unit or team performance, and no
18 link to customer service and/or service reliability objectives. These types of plans
19 act more as an end of year “bonus” than a motivational “pay for performance”
20 system driving specified behavior.

21 **Q: Does PSE have a long term incentive plan?**

22 A: Yes, PSE does provide an equity-based long-term incentive plan using common
23 shares of Puget Energy stock. PSE administers a long-term incentive plan for its
24 officers and directors, in the form of a performance share plan. Based on the
25 current structure of this plan, awards under this plan are fully funded by
26 shareholders and not included in the rate base.

1 Long-term incentives have been the fastest growing component of
2 executive compensation over the last ten years. Today, long-term incentive
3 awards account for approximately one-third of officer pay and are integral to a
4 company's ability to attract and retain management personnel. Under this
5 performance plan, participants are granted a "target" number of shares with a
6 grant value that is market competitive (approximately at the competitive median).
7 Awards are earned based on the Company's cumulative total shareholder return
8 (stock price changes plus dividends) over a four-year period relative to a peer
9 group of gas and electric utility companies. Threshold, target, and superior
10 achievement goals are set before the start of a given performance cycle.
11 Performance requirements are aggressively set such that if relative performance is
12 below the 35th percentile, no awards are earned and TSR performance must be at
13 the 55th percentile (i.e., performance has to be better than 55% of peer
14 organizations) to vest in 100% of the target grant.

15 **Q: How do PSE's incentive plans help ratepayers?**

16 A: Incentive plans have taken on increasing importance in helping utilities provide a
17 competitive "total compensation" package that allows them to compete with
18 general industry companies to attract and retain a competent, stable workforce.
19 As job mobility across industries and the heightened competition for talent has
20 increased in recent years, workforce stability and retention throughout the
21 employee ranks provide several benefits to ratepayers. By retaining well-
22 performing employees, ratepayers benefit not only from the heightened experience
23 of these valued employees but also by minimizing turnover costs arising from
24 recruiting, "downtime" and retraining. In addition, variable incentive
25 compensation helps to manage payroll costs because incentive awards must be
26 "re-earned" every year, unlike traditional base pay which tends to increase every

1 year without directly requiring a corresponding increase in performance.
2 Moreover, well-performing employees who meet these goals are rewarded with
3 incentive pay which tends to increase employee retention and ongoing
4 contributions.

5 Incentive plans are undertaken because the benefits (or performance
6 outcomes) will outweigh the program costs. PSE's pay-for-performance system is
7 designed to increase worker productivity, customer service, cost control, safety
8 and efficiency. All of these goals contribute to two common results: 1) reducing
9 costs, which can then be passed along to ratepayers in the form of reduced rates or
10 which can free up revenues for other investments to benefit ratepayers and
11 2) provide higher levels of customer service or to limit borrowing.

12 The long term incentive plan also benefits PSE's ratepayers, even though
13 the performance measure in the long-term incentive plan is focused on
14 shareholder value, by:

- 15 • Minimizing costs associated with high turnover, including recruiting,
16 training, and “downtime” associated with filling vacant positions;
- 17 • Minimizing the need for additional base pay or annual cash incentive
18 awards to provide “total” competitive pay opportunities; and
- 19 • Providing continuity of the management team to develop and implement
20 effective business strategies that span multiple year periods.

21 IV. PSE INCENTIVE PLAN RESULTS

22 **Q: How is PSE's incentive pay plan funded and allocated?**

23 A: PSE's incentive awards are funded and allocated based on a combination of
24 financial and non-financial operating results. In 2001, Officer and Director target
25 awards represent less than 20% of the total budgeted annual employee incentive
26 pool. Awards at this organizational level are primarily "funded" based on

1 earnings performance. However, as described above, the final award pool is
2 reduced incrementally 10% if threshold performance levels are not achieved on
3 ten distinct customer service quality indices. This performance and award
4 structure is designed to balance the focus on ratepayers and shareholders.

5 Incentive awards for employees below the officer and director level are
6 more directly tied to the achievement of business unit and functional operating
7 performance goals (less than 30% of these awards are directly funded by corporate
8 earnings per share results, and that 30% is modified by SQI performance).

9 PSE employees are told that they will receive a "target" award if future
10 actual results equal those desired. Actual payments are based on results achieved.
11 They are usually below target amounts if the overall performance has not met
12 target objectives, and above target amounts if performance exceeds target
13 performance objectives. The level of goals achieved in one year often provides
14 the minimum funding threshold for similar goals the following year, encouraging
15 continuous improvement. In Exhibit MKG-3, I have provided a graph entitled
16 "PSE Current Target and Most Recent Actual Incentive Awards." This Exhibit
17 shows PSE's actual awards earned (based on results achieved in its incentive plan)
18 compared to PSE's target award opportunities this past year. As demonstrated in
19 Exhibit MKG-3, incentive pay has become a significant ongoing component to
20 competitive annual cash compensation practices at all PSE's organization levels,
21 averaging 9.8% for all employees.

22 **Q: How does the cost of PSE's plans compare with other similarly situated**
23 **companies?**

24 A: PSE's target and actual awards are comparable to opportunity and actual pay at
25 other companies. As the prevalence of variable incentive pay programs has
26 increased in recent years, so have the target (budgeted) and actual awards at each

1 PSE organization level. The PSE payouts under its program are consistent with
2 the Hewitt survey, which reported average payout levels at 10.8% of payroll for
3 salaried exempt employees and 4.5% to 6% for bargaining unit and hourly
4 employees. For further comparison, the table entitled "Utility vs. Industry
5 Comparison" in Exhibit MKG-4 (results of Hewitt's 2001 Total Compensation
6 Measurement DataBase™) summarizes the average range of target and actual
7 annual business incentive awards (expressed as a percentage of base pay) at three
8 organization participant levels: Director and Officer, Other Exempt, and
9 Nonexempt employees. Again, PSE's most recent target awards (expressed as a
10 percentage of base pay) shown in Exhibit MKG-3 vary from 10% for non-exempt
11 employees to 30% of base pay for Director level and above. This compares with
12 the utility and industry median (i.e., 50th percentile) target opportunity found in
13 Exhibit MKG-4, ranging from 8% for non-exempt to 30% for Director level and
14 above. Overall, PSE's actual awards paid in 2001 exceeded target levels based on
15 performance results. Similarly, in the industry comparisons, actual awards at the
16 75th percentile exceeded target for the plan year.

17 **Q: Does PSE's incentive pay plan correlate with PSE's overall performance?**

18 A: As described in the testimony of John Shearman, PSE has achieved operation and
19 maintenance costs that are among the lowest in the nation and system safety and
20 service reliability performance trends that are better than the industry average. In
21 my opinion, PSE's annual variable goals and incentive pay program has been a
22 significant contribution to PSE's ability to achieve such results since its
23 introduction in 1998.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

Q: Based on your analysis, what conclusions have you drawn about PSE's variable incentive compensation program?

A: PSE's variable incentive compensation program is consistent with market practices and effective at aligning employees with its business mission to be the "Best Distribution Company." The design and administration of the programs appears to correlate with results that benefit PSE's ratepayers. Its commitment to goal setting at all levels of the organization, establishment of "stretch" goals, and ongoing communication serve to motivate employees and create a clear focus on accountability. In sum, PSE's program motivates employee performance, aligns employee behavior with company goals, and helps to attract and retain employees, all of which are critical to the success of a high-performance and efficient energy distribution company in today's competitive business environment.

Q: Does this conclude your testimony?

A: Yes.

[BA013150017]

EXHIBIT NO. _____ (MKG-2)
DOCKET NO. _____
2001 PSE RATE CASE
WITNESS: MARK K. GORDON

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

PROFESSIONAL QUALIFICATIONS OF MARK K. GORDON
ON BEHALF OF PUGET SOUND ENERGY, INC.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

PUGET SOUND ENERGY, INC.

PROFESSIONAL QUALIFICATIONS OF MARK K. GORDON

Q: Would you describe your employment experience?

A: I work with a broad range of public and private general industry corporations including utility and energy service businesses in the Western United States. I have over fifteen years of management consulting experience with Hewitt, specializing in executive and broad-based compensation program strategy, design and implementation.

Q: What does Hewitt do?

A: Hewitt is a global management consulting and outsourcing firm specializing in human resources solutions. With more than 12,000 associates working in 37 countries worldwide, our client roster includes more than two-thirds of the Fortune 500 and more than a third of the Global 500. Since 1940, Hewitt has provided thousands of organizations, including numerous electric and gas utilities and energy services companies, with a broad range of services related to employee compensation. Our compensation consulting services include setting rewards strategy, competitive market analysis using a library of published, private and proprietary survey sources, incentive design and communications.

Q: Would you describe your educational background?

A: I have a Bachelor's degree in Psychology and a Master's degree in Business Administration from the University of California at Berkeley.

[BA013150017]