

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-11_____

DOCKET NO. UG-11_____

DIRECT TESTIMONY OF

KAREN S. FELTES

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

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

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

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

Q. What is the scope of your testimony?

A. I will provide an overview of Avista's Compensation Program, employee benefits and, in response to the Commission Order No. 7 in Docket Nos. UE-100467 and UG-100468, I will explain why the costs associated with Avista's employee incentive plan are appropriate as part of the total compensation for employees.

- 1 ▪ Pay competitively compared to other employers within our market,
- 2 ▪ Drive performance to meet goals and objectives, and
- 3 ▪ Reward outstanding performance.

4
5 The market-based pay program reflects the competitive pay ranges and incentive target
6 opportunities of other utilities, regionally and nationally, as well as other industries. Our
7 compensation program is supported by performance management systems that focus on
8 measuring and improving both utility and individual performance.

9 Avista's benefits program offers a comprehensive package that strives to provide
10 employees with the coverage needed to meet medical and retirement needs at competitive levels.

11 Avista recognizes that teamwork is vital to the success of the organization and, where
12 appropriate, provides group-based awards measured on a company-wide basis. Additionally,
13 consistent with competitive industry practice, individualized and group-based incentive programs
14 are designed to reward outstanding individual and specific performance targets collectively.
15 Avista also recognizes the specific efforts and achievements of groups and/or individuals through
16 various monetary and non-monetary programs.

17 **Q. What are the factors that drive the design of the benefits program offered to**
18 **employees?**

19 A. The Company's benefit programs are designed to be cost effective, competitive
20 with other organizations in the utility industry, and attract and retain qualified employees.
21 Competitive market data is monitored on an on-going basis to ensure the total benefit program is
22 competitive with other companies in the industry, and at the same time is cost effective.

23 The Company assesses the competitiveness of the benefits program by looking at
24 comparable value indices developed by Towers Watson, a nationally recognized consulting firm

1 and Mercer, an insurance broker. Also, comparable benefit data reviews are performed
2 periodically with other regional utilities and other industries.

3 **Q. Please explain how market data is attained and used by the Company to**
4 **determine whether its salary structure is competitive as compared to others in the**
5 **industry?**

6 A. Avista participates in numerous confidential salary surveys provided by third-
7 party consulting firms, which compare Avista's pay programs to other organizations in the utility
8 industry labor markets, as well as other industries, regionally and nationally. Salary surveys are
9 used for projecting salary increase estimates and salary range changes, as well as benchmarking
10 jobs to market data. Avista benchmarks many jobs within the Company and reviews the market
11 data to determine if the salary range midpoints still accommodate the new estimated market
12 values established by the benchmarking analysis process. An example of this report "Salary
13 increase budget comparison 2010/2011" is included as Exhibit No.__(KSF-2), pages 1 - 3.

14 In May 2010, the Avista Compensation Committee of the Board of Directors (Board)
15 agreed to set a minimum salary increase budget of 2.5% for 2011 based on the compensation
16 survey data received from the Conference Board (a third-party consulting firm). In November
17 2010, the Board reset the 2011 total salary estimate for non-union employees to 2.8% which was
18 at or near the average projection for the utility industry as well as other industries, regionally and
19 nationally, as shown in Exhibit No.__(KSF-2), pg. 1.

20 Similarly, based on historical data collected from 2008 to 2010 on actual salary amounts
21 granted by other organizations, Avista is estimating salary increases for 2012 to be at a minimum
22 of 2.5% for non-union employees. This increase was presented to the Compensation Committee
23 of the Board of Directors and was approved at the Board's May 2011 meeting. (See Company

1 witness Ms. Andrews's testimony, Exhibit No. ____ (EMA-1T), for salary increases included in
2 the Company's request).

3 Board approval in May 2011 of the minimum expected salary adjustment for 2012
4 provides certainty regarding the minimum increase in salary expense the utility will experience
5 in 2012. As we move closer to 2012, the Board can choose to grant a higher salary adjustment if
6 the updated market data shows that a higher increase is warranted. If the possibility were to
7 occur that the minimum salary increase approved by the Board in May 2011 for 2012 is higher or
8 lower than the updated market data would support, then the Board would make an appropriate
9 salary adjustment for 2013 to ensure alignment with the market data over time.

10 **Q. Has the economic downturn impacted Avista's compensation program as it**
11 **competes for qualified employees?**

12 A. Yes. Avista carefully explored various options surrounding compensation and
13 benefit programs to assess whether eliminating or reducing various programs would be
14 appropriate given the economic downturn regionally and nationally. We concluded that freezing
15 salaries or eliminating programs such as the incentive plan would have unintended
16 consequences. For example, we participate in annual benchmark surveys as discussed earlier.
17 We compete for engineers, technical professionals such as system operators, as well as
18 individuals in finance that have utility experience. If we were to freeze salaries or eliminate
19 incentives, it is clear to us that within one to two years after freezing wages, Avista would have
20 to make market adjustments to bring current employee salaries up to market levels. Therefore,
21 we have taken a measured approach to the salary adjustment that allows us to provide lower
22 salary increases, yet keep pace with the market until such time that the economy returns to a
23 more normal place.

1 Also, we know that to hire individuals into the Company we have to compete at the
2 market level from a total compensation basis; therefore, if we were to freeze salaries internally,
3 we most likely would have to pay new employees the going market level and would create
4 compression for existing employees. This creates dissatisfaction and can cause current
5 employees to seek employment elsewhere. Avista recognizes that the economic downturn has led
6 to increased unemployment and caused some companies to freeze all salaries or provide no or (as
7 shown above for Avista) provide lower increases to its employees. However, the utility industry
8 continues to face labor and managerial shortages that challenge our ability to lead key business
9 functions and staff significant infrastructure projects. In order to fill needed skill sets and remain
10 competitive in hiring, most utilities, including Avista, have not made significant changes to their
11 compensation programs or instituted overall salary freezes.

12 Half of our employee population is unionized, which creates another level of complexity
13 to our compensation program, in that we recruit from our union population to fill non-union
14 positions that need technical skills to perform the duties. For example, our system operator
15 positions tend to be staffed by employees with experience in transmission, generation or
16 distribution operations. Recently we filled two positions for distribution dispatcher (a non-union
17 position) from our line operation area. It was necessary to provide these individuals with a wage
18 rate that was above the current contractual union rate, positioning their wages equal to or slightly
19 above current non-union employees who have been performing the job over several years. This
20 type of scenario creates pay issues within key/critical positions that are essential to safe and
21 reliable energy service for our customers. In order to fill needed skill sets and remain competitive
22 in hiring from the union sector to filling non-union positions, most utilities with union personnel,

1 including Avista, have tried to keep wage increases parallel within their organizations whenever
2 possible.

3 **Q. How are union wage increases determined?**

4 A. Union wage increases are governed by contract between the Company and the
5 unions. The union contract was effective March 26, 2010 and expires March 25, 2014. Effective
6 March 26, 2010 and March 26, 2011 the union received contractual wage increases of 3.5% and
7 3.0%, respectively. The contract also provides for a 3.0% wage increase for 2012 and 2013.
8 Confidential Exhibit No. ____ (KSF-2C) shows the historical lineman wages in the Northwest.

9 **Q. What steps has the Company taken to evaluate Officer Compensation?**

10 A. The Compensation and Organization Committee of the Board of Directors is
11 responsible for overseeing and setting the officer compensation levels within the total
12 compensation plan. The Committee, working in conjunction with their outside executive
13 compensation consultant, conducts annual reviews of the marketplace data for the energy and
14 utility industry. The Compensation Committee has articulated a clear philosophy to set the pay
15 of executive officers at the middle of the market for the utility industry. This is the same
16 philosophy that is set by Avista for all employees, both union and non-union. The compensation
17 programs are intended to align the executive officer interests with those of our shareholders and
18 customers by rewarding performance that meets or exceeds the goals the Compensation
19 Committee establishes with the objective of increasing shareholder and customer value. In
20 accordance with the pay-for-performance philosophy, the total compensation received by
21 executive officers reflects corporate and operational performance measured against annual and
22 long-term performance goals. With this in mind, the officer's total compensation is comprised of
23 a mix of base salary, annual incentive compensation and long-term incentive awards. A portion

1 of the total base salary and annual incentive compensation is born by customers and a portion by
2 shareholders, whereas the long-term incentive award is borne solely by shareholders.

3 The executive compensation programs are designed to focus our executive team on
4 achieving solid financial results, controlling costs, maintaining system reliability, and delivering
5 outstanding customer service. The compensation structure also serves as a tool to help motivate,
6 retain, and attract a highly experienced, successful executive team to manage the Company.

7 The total compensation program does not provide for guaranteed bonuses and has
8 multiple performance measures. Annual cash incentive components focus on both the actual
9 results and the sustainability and quality of those results. Each component of the short and long-
10 term plans is either fixed or capped with respect to the payout opportunity; so the plan does not
11 result in an unlimited payout. The design of the annual cash incentive plan creates a balanced
12 focus on financial results and system sustainability over time which helps to mitigate risky
13 decision-making practices.

14 Because the Compensation Committee believes the total compensation program provided
15 to executive officers is fair and market competitive, the Company does not provide any
16 additional benefits in the form of perquisites to the CEO or any other officer.

17 **III. EMPLOYEE BENEFITS**

18 **Q. Please describe the Company's employee benefit plans.**

19 A. The Company offers a comprehensive benefit plan for employees. Employees
20 have several choices as to type of medical plan, dental plan, life insurance, etc., so that they can
21 determine the best fit for their circumstances. The Company works with a third party
22 administrator to determine the annual rates for the Company and for each individual employee
23 based on their elections.

1 common objectives that are designed to align the interests of employees with the interests of our
2 customers. Establishing specific targets for each element, measuring progress toward meeting
3 the targets, and paying an incentive for achieving them motivates employees to focus on the key
4 elements each year.

5 **Q. In general terms, how is the pay-at-risk component incorporated into a total**
6 **compensation package for employees?**

7 A. Avista is committed to providing a total compensation program that provides base
8 salaries, performance-based award programs and benefits that are competitive in the
9 marketplace. Market data shows that pay-at-risk or variable pay plans are prevalent in over 80%
10 of organizations, and most utilities, including Avista, have some kind of pay-at-risk plan.

11 The Company views the Plan as a competitive necessity, and a driver of desired behavior
12 among employees, as well as a means to achieve cost-control. For example, if the existing
13 incentive plan were to be eliminated, base salaries would need to be adjusted in order for
14 Avista's total compensation to remain competitive with other utilities.

15 A pay-at-risk component of compensation is not designed to pay out the full incentive
16 opportunity every year, nor is it designed to have no payout for an extended period of time. Pay-
17 at-risk plans are designed to help focus employees on making decisions that benefit the Company
18 and its customers, while at the same time functioning as an integrated component of total
19 compensation. As I noted earlier, most utilities have some form of pay-at-risk component in their
20 total compensation program.

21 **Q. Please review the evolution of the Company's incentive plan.**

22 A. In the Company's most recent order No. 7, Dated November 19, 2010, in Docket
23 Nos. UE-100467 and UG-100468, the Company was ordered to review its non-executive

1 incentive plan, by identifying, explaining and to the extent possible, quantifying the program's
2 benefits to ratepayers as well as explain how the program complies with the Commission's Final
3 Orders in previous Avista general rate cases in Docket Nos. UE-991606 and UE-090134.

4 The incentive plan reviewed by the Commission in UE-991606 was the corporate plan
5 that covered the period from January 1, 1999 to December 31, 1999. This Plan was based solely
6 on Corporate Earnings per Share (EPS) which funded the incentive award pool of dollars. If the
7 Company met EPS at or above the Threshold performance level, then 50% of the funds would be
8 allocated equally to employees based on achieving the Company's goals. The other 50% would
9 be allocated at the discretion of management based on an assessment of the employee's
10 performance and contributions during the year. Payments under this Plan ranged from 0% to
11 200% depending on the level of performance achieved.

12 **Q. How has the Company changed its incentive program since 1999 to address**
13 **the concerns by the Commission?**

14 A. In 2001, Avista reengineered its employee incentive plan to drive strategic
15 objectives and to address concerns the Commission voiced in UE-991606 regarding the incentive
16 plan of 1999.

17 The plan that was implemented in 2002 addressed the concerns of the Commission by
18 focusing employees on controlling O&M costs per customer by improving our processes and
19 driving efficiencies to better manage the business (O&M cost per customer and capital
20 spending), while paying close attention to our customers' voices regarding the products and
21 services we provide (customer satisfaction and reliability). Avista has since continued to
22 calibrate the Plan over the years to focus employees in the direction that the Company is striving
23 for in order to benefit the customer.

1 As the Commission suggested, we created an O&M cost per customer metric to focus the
2 business on controlling costs and driving efficiencies in order to keep our costs reasonable for
3 our customers. When controlling costs, sometimes there are unintended consequences such as the
4 level of service drops due to budget cuts or jobs are reduced that may impact how fast we can
5 restore power to customers. In order to balance the focus of controlling costs and yet provide a
6 satisfactory level of performance for our customers, we added three performance triggers to the
7 Plan that we believe were critical to the business. First, we use a customer satisfaction survey to
8 track satisfaction levels of customers that have had recent contact with us. Second, our reliability
9 measure is the average restoration time for sustained outages. The industry acronym for this
10 measure is CAIDI - Customer Average Interruption Duration Index. Third, the method
11 previously tracked capital spending by comparing the actual capital dollars spent to the capital
12 budget. In 2004, we eliminated the capital spending trigger from the employee Plan.

13 In 2005, we added another minimum performance trigger to create a more balanced
14 approach to electric reliability. The industry acronym for this measure is SAIFI - System
15 Average Interruption Frequency Index, which measures the number of customers which had
16 sustained outages (> 5 minutes), divided by the number of customers served. Not only are we
17 watching our restoration time, but we are watching how many outages our customers are
18 experiencing. By starting with a sustainable design and a philosophy to benefit our customers
19 we have the ability to make changes to the plan as we learn by focusing on these areas year over
20 year.

21 In 2009, we reengineered the Plan template again. We kept the same measurements:
22 O&M Cost per Customer, Customer Satisfaction, CAIDI and SAIFI, but revised the way the
23 Plan worked. Each measure became an independent component to the total incentive award

1 opportunity. Each had its own target to achieve. Avista still believes that customer satisfaction
2 and reliability of service is the core objective to our business therefore, these non-financial
3 measures were designed as a meets or not meets metric. If the acceptable standard target set is
4 not met, then the plan does not pay out that portion to any employee.

5 In 2010, we kept the same Plan template from 2009 but revisited the reliability measure
6 and recalibrated the methodology for creating the O&M Cost per Customer target. The Company
7 combined three indices into one reliability index to be used in the Plan, and added a sharing
8 mechanism to the cost per customer target.

9 As for the 2011 Plan, we again are keeping the same Plan template from 2009 and 2010,
10 but introducing a new natural gas response time measure as a non-financial metric providing a
11 balanced approach to both electric and natural gas reliability. The Company is also implementing
12 another non-financial measure called "Performance Excellence". This measure will be based on
13 achieving a certain number of performance excellence milestones during 2011. Once final, the
14 Board reviews and approves the plan each year.

15 **Q. How does the Company's Incentive Plan benefit customers and how do**
16 **employees contribute to the results?**

17 A. Avista's Employee Incentive Plan provides several benefits to customers. The
18 plan focuses work groups and individuals on key objectives of the Company, which are
19 reliability, customer service and cost-control. When we have all employees focused on overall
20 cost-control this translates into sustaining lower rates by reducing the level of expense below
21 what it otherwise would have been.

22 Employees contribute to these measures in their daily work or on special projects in
23 varying degrees. When employees are faced with problems or issues, they are engaged enough to

1 take it upon themselves to come up with solutions, such as designing squirrel guards or osprey
2 nests in order to reduce outages caused by animals, or save on printing costs by defaulting all
3 Avista printers to black and white, using double-sided print copies, or choosing electronic pay
4 statements rather than printed statements. In order to obtain sustainable, process improvements
5 and efficiencies over time, it requires having all employees thinking about innovation and
6 workable solutions.

7 There are many examples of productivity initiatives over the past year. We have provided
8 the media and our customers direct access to outage information from our Outage Management
9 Tool on Avista's website. The number of media calls our Corporate Communications team had
10 to field during outages was reduced by 55 percent (2010 calls as compared to 2008). The media
11 and our customers received timely outage information and our Corporate Communications team
12 could reallocate their time to other projects. This productivity initiative helps us avoid the future
13 expense of having to add headcount in this area to handle all of the calls and inquiries. This
14 sustainable solution provides a direct benefit to our customers and at the same time allowed us to
15 use our internal resources more effectively.

16 Other examples of productivity initiatives include the installation of 65 electronic relay
17 devices in substations across our service territory, for what our industry calls, 'hot-line holds',
18 and the 2010 issuance of mobile dispatch technology to 65 of our electric trucks. These items are
19 discussed further by Company witness Mr. Kopczynski.

20 These are just a few areas in which our employees have contributed to the measures in
21 our incentive plan. As you can see, they are not always quantifiable and in some cases relatively
22 small savings, however, in total they can add up to substantial amounts. Because we are working
23 towards sustainable solutions, the savings is not always an expense reduction in the moment, but

1 sometimes the solution allows us to avoid increased costs to correct a problem in the future. The
2 incentive plan is a tool we use to recognize employee efforts in driving efficiencies and
3 controlling costs for our customers.

4 Employee dedication and focus on customer satisfaction and efficiency has helped
5 spearhead many of these efforts. Process improvement is part of Avista's culture, and the
6 incentive plan design contributes to the focus employees place on continually looking for more
7 efficient ways to do work, and recognizes employees for their contributions in keeping service
8 reliable and costs reasonable for our customers.

9 **Q. How does the Company's Plan impact employee base salaries thereby**
10 **reducing the level of pay included in customer rates?**

11 A. A compensation program without pay-at-risk would drive base wages upward,
12 which in turn, would increase pension liability costs as well. Having a pay-at-risk component is
13 another way the Company is working to not embed year-over-year costs, and helps to maintain
14 reasonable rates for our customers. The Company's current plan involves a meaningful amount
15 of pay-at-risk for all employees. Therefore, the most direct benefit to customers from the
16 structure of the Incentive Plan is that total compensation is dependent on employees achieving
17 specific objectives that have a direct tie to customer satisfaction and cost efficiency.

18 **Q. Did Avista achieve cost-savings in 2010 as compared to planned expenses for**
19 **the year?**

20 A. Yes. The Company saved approximately \$10.9 million of O&M costs during the
21 2010 test period when comparing actual expenses to those planned for the year. A portion of
22 those savings would have been paid out to employees as part of the incentive plan, but the
23 balance of the savings (approximately \$4.4 million) remain in the 2010 test year as a reduction in

1 costs to the benefit of customers. Company witness Ms. Andrews provides additional details
2 surrounding the expenses included in the test period and the accounting treatment included in
3 this case.

4 **Q. Please describe the Employee Incentive plan in place during 2010.**

5 A. The 2010 Employee Incentive Plan was made up of three utility operations goals:
6 Operating and Maintenance (O&M) Cost per Customer, Customer Satisfaction Rating, and an
7 electricity reliability index. Avista's 2010 Employee Incentive Plan Document is provided in
8 Exhibit No. ____ (KSF-3).

9 **Q. Please explain the Operating and Maintenance Cost per Customer measure.**

10 A. The O&M Cost per Customer measure reflects operating efficiency and customer
11 growth which directly relates to maintaining reliable, cost-effective service levels to run the
12 Company's business efficiently. The 2010 Plan placed emphasis on aggregate utility costs per
13 customer to encourage company-wide teamwork and consistent results in order to keep costs
14 reasonable. The O&M Cost per Customer target is based on the projected number of customers,
15 targeted O&M expense and a savings mechanism between employees and the Company. This
16 measure provides an incentive for employees to keep actual O&M costs as low as possible.
17 Payments under this portion of the Plan can range from 0% to 150% depending on the level of
18 performance achieved.

19 **Q. Please explain the Customer Satisfaction rating measure.**

20 A. The customer satisfaction rating measures the customer's overall satisfaction with
21 the service they received during a recent contact with the service or call center. The rating is
22 derived from a Voice of the Customer Survey, which is conducted each quarter by an
23 independent agency. The measure is widely used in the industry for external reporting. The

1 Company uses a combination of the “satisfied” and “very satisfied” ratings, rather than use the
2 standard satisfied rating, which is typically used in the industry. By combining these two
3 measures it actually makes the target more difficult to achieve. Payments under this portion of
4 the Plan can only be achieved if the target is met. This element of the plan is set as a meets or not
5 meets target. There is no payment under this portion of the plan if the target is not achieved. For
6 2010, the target was set at 90%.

7 **Q. Please now explain the reliability index measure.**

8 A. Providing reliable energy to our customers is the backbone of Avista’s business,
9 therefore, it makes good sense for us to focus on reliable service levels for our customers. This
10 target in the Employee Incentive Plan is a measure that tracks how quickly the Company restores
11 outages, how frequently customers are affected by outages and what percent of customers are
12 experiencing more than three sustained outages per year. We combined three common industry
13 indices in order to balance our focus of electric reliability. The Company tracks the average
14 restoration time for sustained outages that affect our customers (CAIDI) and the average number
15 of sustained outages per customer (SAIFI). The third metric is fairly new to the utility industry
16 and measures the percentage of customers that experience more than three sustained outages in
17 the year (CEMI³). We chose this level of outages over others because industry data received
18 from JD Power’s customer service surveys indicate that customers are more apt to be dissatisfied
19 after three outages. Each metric has a set target to achieve and then are weighted equally (one-
20 third of 100%) and combined into one index. Focusing on these measurements enables the
21 Company to direct our resources appropriately and efficiently in order to contain costs and plan
22 for future infrastructure upgrades that will benefit the customer. Payments under this portion of

1 the Plan can only be achieved if the target is met. There is no payment under this portion of the
2 plan if the target is not achieved.

3 **Q. Does Avista's Employee Incentive Plan apply to employees who are subject**
4 **to collective bargaining agreements?**

5 A. Yes. Union employees are eligible under the same Plan as non-union employees.
6 However, Local 77 union employees are paid a flat dollar amount rather than a percentage of
7 base salary. Under the 2010 plan union employees received an average of \$817 for achieving the
8 goals set forth in the Plan.

9 **Q. How is the Company's incentive plan structured for the Company's**
10 **executive officers?**

11 A. The executive officer incentive plan has the same operational components as the
12 employee incentive plan plus two earnings components: Utility Earnings per Share (EPS) and
13 Non-Utility Earnings per Share. The weightings for each component are: 50%-Utility EPS, 10%-
14 Non-Utility EPS, 30%-O&M Cost per Customer, 6%-Customer Satisfaction, and 4%-Reliability
15 Index. Although the weightings on the operational components are different from the employee
16 plan, the goals or targets are the same. All incentive payouts associated with utility or non-utility
17 EPS (60% of total incentive award) are excluded from utility expense and are paid by
18 shareholders.

19 **Q. Overall, why should the Company's incentive plan be included in rates?**

20 A. We believe Avista's total compensation philosophy creates the right focus for
21 employees because the incentive plan places a portion of employees overall earning opportunity
22 at risk. Employees, as a whole, have to achieve the goals of the incentive plan for the plan to
23 payout. We believe this tension in plan design helps motivate and focus employees on the stated

1 goals of the plan. In order to achieve this additional level of compensation, employees have to
2 keep working smarter and keep focused on cost control, customer satisfaction and reliability
3 within the system.

4 We believe that Avista's existing total compensation plan is correctly weighted to
5 motivate and retain current employees, while remaining competitive enough to attract qualified
6 employees.

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

8 A. Yes.