BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power For Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of Its Proposed Service Schedules and Electric Service Regulations	**Docket No. 10-035-124** **DPU Exhibit No. 10.0D-RR**

Direct Testimony of

Mark E. Garrett

REVENUE REQUIREMENT

For the Division of Public Utilities

Department of Commerce

State of Utah

May 26, 2011

TABLE OF CONTENTS

I. INTRODUCTION 2

II. PURPOSE AND RECOMMENDATION 3

III. CASH WORKING CAPITAL 4

IV. O&M EXPENSE ESCALATION 13

V. PAYROLL AND RELATED EXPENSES 15

VI. INCENTIVE COMPENSATION 21

VII. MEDICAL EXPENSE 24

VIII. INSURANCE EXPENSE 25

IX. CONCLUSION 26

Direct Testimony of Mark E. Garrett

I. INTRODUCTION

1 **Q. Please state your name and occupation.**

2 A. My name is Mark E. Garrett. I am an independent consultant specializing in public
3 utility regulatory issues.

4 **Q. What is your business address?**

5 A. My business address is First National Center, Suite 1400 West, 120 North Robinson
6 Avenue, Oklahoma City, Oklahoma 73102.

7 **Q. On whose behalf are you appearing in these proceedings?**

8 A. I am testifying on behalf of the Division of Public Utilities (Division).

9 **Q. Please describe your educational background and professional experience related to**
10 **utility regulation.**

11 A. I received my bachelor's degree from the University of Oklahoma and completed post
12 graduate hours at Stephen F. Austin State University and at the University of Texas at
13 Arlington and Pan American. I received my juris doctorate degree from Oklahoma City
14 University Law School and was admitted to the Oklahoma Bar in 1997. I am a Certified
15 Public Accountant licensed in the States of Texas and Oklahoma with a background in
16 public accounting, private industry, and utility regulation. In public accounting, as a staff
17 auditor for a firm in Dallas, I primarily audited financial institutions in the State of Texas.
18 In private industry, as controller for a mid-sized ($300 million) corporation in Dallas, I
19 managed the company's accounting function, including general ledger, accounts payable,
20 financial reporting, audits, tax returns, budgets, projections, and supervision of

21 accounting personnel. In utility regulation, I served as an auditor in the Public Utility
22 Division of the Oklahoma Corporation Commission from 1991 to 1995. In that position,
23 I managed the audits of major gas and electric utility companies in Oklahoma. Since
24 leaving the Oklahoma Corporation Commission, I have worked on various rate cases and
25 other regulatory proceedings in several states on behalf of industrial interveners,
26 commercial interveners, municipalities, consumer advocates and commission staff.

27 **Q. Have you previously testified before the Public Service Commission of Utah**
28 **(Commission)?**

29 A. Yes.

30 **Q. Have you testified before other commissions and were your credentials accepted in**
31 **those proceedings?**

32 A. Yes. I have testified in regulatory and civil proceedings in several states and my
33 qualifications as an expert in utility ratemaking matters have been accepted. A more
34 complete description of my qualifications and a list of the proceedings in which I have
35 been involved are included (as Attachment A) at the end of my testimony.

36 **II. PURPOSE AND RECOMMENDATION**

37 **Q. What is the purpose of your testimony that you are now filing?**

38 A. My testimony presents the Division's position regarding several revenue requirement
39 issues in this case. I address cash working capital issues, O&M expense escalation,
40 payroll and benefit expenses, and insurance expense. My testimony explains the basis for
41 these positions and provides analysis and support for the proposed adjustments and
42 recommendations. The adjustments are set forth on both a total-Company and Utah

43 jurisdictional basis.

44 **III. CASH WORKING CAPITAL**

45 **Q. Please describe the Company's requested allowance for cash working capital?**

46 A. The Company has requested a cash working capital allowance in this proceeding based
47 on a 2007 lead-lag study.[1] Consistent with the Commission's current cash working
48 capital policy,[2] the Company excluded depreciation expense, interest expense on long-
49 term debt, and dividends on both preferred stock and common stock from its lead-lag
50 calculations.

51 **Q. Were issues regarding the cash working capital methodology addressed in a prior**
52 **rate case?**

53 A. Yes. In a previous rate case, Docket No. 07-035-93, both the Division and the
54 Committee were critical of the Company's cash working capital allowance request
55 because it was based on a lead-lag study that was several years old at the time and was
56 missing the underlying support data. The Committee further criticized the study because
57 it excluded interest expense on long-term debt in the cash working capital calculations.
58 In its final Order, the Commission stated that it agreed with the Division and the
59 Committee regarding the need to update the cash working capital study in the Company's
60 next general rate case. In that order, the Commission did not adopt the Committee's
61 recommendation to include interest expense in the study, but rather preserved the issue
62 for a determination in a later proceeding. Specifically, the Commission quoted from its
63 order in Docket No. 93-057-01 addressing the policy of <u>excluding</u> (1) depreciation, (2)

[1] Supplemental Exhibit RMP (SRM-1S), tab 2.33.
[2] UPSC Docket No. 07-035-93, Order issued August 11, 2008.

64 interest expense, (3) preferred dividends, and (4) common dividends from the cash
65 working capital calculations stating: "If this method is to be changed, a strong burden of
66 persuasion will first have to be met which must include a comprehensive analysis of all
67 four of the above mentioned items." Although testimony addressing these issues was
68 filed in the next rate case, a settlement was reached in that case and the cash working
69 capital issues were not addressed in that settlement, and consequently, not in the
70 Commission's order.

71 **Q. What is the scope of your testimony on cash working capital in this proceeding?**

72 A. My testimony in this proceeding provides a conceptual overview and discussion
73 regarding the proper treatment within a lead-lag study for the four items set forth above:
74 interest expense, preferred dividends, depreciation expense and common equity. The
75 specific calculations of revenue and expense days in the lead-lag study and the resulting
76 adjustments are addressed in the Lead Lag Summary tab in the JAM model exhibit 8.1,
77 and in the DPU Revenue Requirement spreadsheet exhibit 8.2, included in the testimony
78 of Division witness Ms. Brenda Salter. This adjustment results in a revenue requirement
79 decrease of approximately $2.3 million on a Utah-allocated basis.

80 **Q. What is cash working capital?**

81 A. Cash working capital is often defined as the net cash outlay that a utility must furnish to
82 provide service before payment for that service is received from the customers.[3]
83 However, it is common today for a major utility to receive payments from its customers
84 before the various obligations of the company to its vendors and employees that relate to

[3] See *Accounting for Public Utilities*, § 5.04.

85 those services become due. This creates a situation where the customers are actually
86 supplying the company with cost-free capital, and a reduction to rate base is appropriate
87 in these situations. A utility company's ability to negotiate large contracts
88 advantageously, coupled with its utilization of sound cash management techniques will,
89 in most situations, produce a negative cash working capital requirement.

90 **Q. How does one determine whether customers or investors actually supply the utility's**
91 **cash working capital?**

92 A. A lead-lag study is the most accurate method available to determine whether the
93 company or the customer actually provides the cash that pays the bills for the day-to-day
94 operations of the company. A lead-lag study compares the timing differences between
95 the inflows of cash from revenues and the outflows of cash for operating expenses. The
96 net difference is expressed as a positive cash requirement if the Company is supplying
97 cash to pay its day-to-day operating expenses before payments for these services arrive
98 from customers and as a negative cash requirement if payments from customers actually
99 arrive before the Company is obligated to pay its various expenses. These differences are
100 expressed in the number of days between the time the Company pays its bills and the
101 time the customers remit their payments.

102 **Q. How is depreciation expense generally treated in lead-lag studies?**

103 A. A fundamental principle of the cash working capital allowance is that any non-cash cost
104 items such as depreciation, deferred income tax, and return on common equity are
105 excluded from the calculations. These items are excluded because lead-lag studies are
106 intended to measure the timing differences in the collection and disbursement of cash.

107 Noncash items have no impact on these timing differences. Depreciation is referred to as
108 a "noncash" expense because there is no *cash outlay* required when a company records
109 depreciation expense, as there is with a "traditional cash" expense item such as payroll
110 expense, operating expense, interest and taxes. Moreover, depreciation expense is the
111 mechanism for the "return of" capital to investors. Investors are aware of the timing
112 differences associated with the return of their capital through depreciation recoveries and
113 are compensated through the rate of return they charge for the use of their money. For
114 these reasons, the Commission should continue its current policy of excluding
115 Depreciation Expense from any lead-lag cash working capital study.

116 **Q. How is common equity generally treated in a lead-lag study?**

117 A. Like depreciation expense, common equity is <u>not</u> part of the lead-lag analysis. From time
118 to time, a utility will seek to include the dividends on common stock, or other costs
119 associated with common equity in the lead-lag calculations. These attempts are
120 inappropriate and almost universally rejected, as is the case in this jurisdiction.[4]
121 Common equity is generally excluded from the calculations because the return on
122 common equity is a "noncash" item. In other words, there is not a current cash outlay
123 requirement associated with common equity.

124 In addition, common equity is excluded from the calculations because when
125 equity is returned to the company through rates, funds in the possession of the company
126 are deemed in possession of the owners of the company. At that point, it is up to the
127 owners of the company to decide when and how the funds are either reinvested in the

[4] Also, for example, see Oklahoma Corporation Commission, Cause No. PUD200500155, Order No. 516261.

128 company or dispersed among the owners. Ratepayers cannot be held accountable for
129 timing differences associated with the return of common equity once the equity is in the
130 control of the company, since the ultimate disposition of the equity at that time is
131 completely up to the owners of the company and wholly outside the control of ratepayers.
132 Moreover, the capital markets are sufficiently aware of the timing differences
133 associated with the return of capital to the company, and have included the cost of those
134 timing differences in the return component required for common equity. In other words,
135 the cost of equity required in the capital markets (i.e. the ROE) takes into account how
136 capital is returned to the company, including any timing differences associated with its
137 collection from ratepayers and its ultimate disbursement among the owners. Thus, equity
138 owners are compensated for the use of their money through the return on equity
139 component in the ratemaking formula and there is no need to compensate them again
140 through an additional return on cash working capital. For these reasons, the Commission
141 should continue its current policy of excluding Common Equity from the lead-lag
142 calculations.

143 **Q. How is Interest Expense on long-term debt generally treated in a lead-lag study?**

144 A. In my experience, unlike depreciation expense and common equity, the interest expense
145 on long-term debt is generally <u>included</u> in cash working capital calculations. There are a
146 number of reasons for this treatment. First, unlike "noncash" items such as depreciation,
147 and common equity, interest expense is included in the cash working capital calculations
148 because it is a "cash" item. In other words, there is a current cash outlay associated with
149 this expense. Also, money collected from customers to pay interest expense on long-term

150 debt is not the Company's to keep. Instead, the Company is obligated to remit these
151 funds to the creditors of the Company under a very specific timetable. During the period
152 between when the money is collected from customers and when it is paid to the creditors,
153 the Company has use of these funds to meet the day to day operating needs of the
154 Company. Further, the Company actually uses these funds for this purpose, as evidenced
155 by the fact that the Company does not segregate these funds in a separate account but
156 rather commingles the funds in the operating accounts of the Company.

157 **Q. How are Preferred Dividends generally treated in a lead-lag study?**

158 A. The treatment of Preferred Dividends is generally not itself a major issue in cash working
159 capital calculations because the cost amounts are often immaterial. However, the
160 treatment of preferred shares in a lead-lag study would depend in part on the
161 characteristics of the shares. Preferred stock often has the characteristics of both debt and
162 equity. While preferred shares generally have priority over common shares for dividend
163 payments they typically have no voting rights. Without voting rights, preferred
164 shareholders are often viewed more as creditors than owners of the company without any
165 control over how and when earnings are distributed and/or reinvested. For this reason,
166 dividends on preferred shares generally should receive the same treatment as interest on
167 long-term debt and therefore should be included in the cash working capital calculations.

168 **Q. Can you provide examples of other lead-lag studies where the cash working capital**
169 **calculation excludes depreciation and common equity but includes interest expense**
170 **on long-term debt as outlined above?**

171 A. Yes. I am regularly involved in rate cases in Oklahoma and Nevada where the treatment
172 outlined above is consistently followed. For example, in AEP-PSO's last rate case, both
173 interest expense on long-term debt and preferred stock dividends were included in the
174 lead-lag study, while depreciation expense and return on common equity were
175 specifically excluded from the calculations.[5] This presentation is consistent with prior
176 Oklahoma Corporation Commission orders where interest expense is included in the
177 lead-lag calculations and noncash items such as depreciation expense and return on
178 common equity are excluded.[6] Likewise, in Nevada, the utilities in that state file lead-lag
179 studies in their rate case applications that include interest expense on long-term debt but
180 do not include depreciation expense and return on common equity.[7] Preferred stock is
181 included in the schedule, but with a zero balance. This presentation is consistent with the
182 Nevada commission's treatment of these items in prior cases.

183 **Q. Are you aware of other jurisdictions that follow this approach?**

184 A. Yes. My understanding is that the Kansas Commission includes interest on long-term
185 debt but not depreciation or common equity in the analysis of cash working capital.[8] I
186 also know that the Arizona Corporation Commission addressed these specific issues in
187 Decision No. 69663 in the recent APS rate case, Docket No. E-01345A-05-0816. In that
188 case, APS had included depreciation expense in its lead-lag study and had excluded

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[5] See Schedule E-1 filed in American Electric Power – Public Service Company of Oklahoma's application in Cause No. PUD 200800144.

[6] In Oklahoma, the larger gas and electric utilities, Oklahoma Gas & Electric, Public Service Co. of Oklahoma, and Oklahoma Natural Gas Co., all present lead-lag studies in their rate case applications to support either a positive or negative cash working capital allowance. In Oklahoma, interest expense on long-term debt is included in the cash working capital calculation while depreciation expense and return on common stock are excluded.

[7] See Schedule G-5, Page 1 of 1, Franklin, filed in Nevada Power's application in Docket No. 08-12002.

[8] See for example, Section 6, Schedule 6-H in the Kansas Gas Service's rate case Docket No. 06-KGSG-1209-RTS and Schedule 16 in the Kansas City Power and Light rate case, Docket No. 06-KCPE-828-R75.

189 interest expense on long-term debt. Both Staff and the Residential Utility Consumer's
190 Office ("RUCO") recommended the opposite treatment for both items. The Arizona
191 Commission reviewed testimony and legal briefs on both issues and provided a thorough
192 analysis in its final order to support its decision that the cash working capital allowance
193 should include interest expense and exclude depreciation expense in the analysis. With
194 respect to *depreciation expense* the Arizona Commission stated:

> 195 There is no "cash expense" incurred by APS when it records depreciation.
> 196 It does not have to find cash to pay itself one month and then pay itself
> 197 back the next. As pointed out by RUCO, an allowance for cash working
> 198 capital is to address cash flow timing problems, not "regulatory lag" issues
> 199 related to earnings. . . . While it may be true that APS needs more cash,
> 200 artificially increasing cash working capital to increase rate base and
> 201 thereby operating income, is inappropriate.[9]

202 With respect to *interest expense* the Commission stated:

> 203 Although interest expense is a non-operating expense, the ratemaking
> 204 formula provides for the recovery of the periodic payments to debt
> 205 holders, and the evidence shows that the Company has the use of these
> 206 funds for an extended period of time before payments are required to be
> 207 made. We will continue to include interest expense in the cash working
> 208 capital calculation.[10]

209 **Q. Do you know of jurisdictions where a different methodology is used?**

210 A. Yes. In Texas, commission rules specifically exclude all "noncash" items from
211 consideration. However, the list of "noncash" items includes depreciation, amortization,
212 deferred taxes, prepaid items and return (including *interest on long-term debt and*

[9] Arizona Corporation Commission, Docket No. E-01345A-05-0816, Decision No. 69663, page 8.
[10] Arizona Corporation Commission, Docket No. E-01345A-05-0816, Decision No. 69663, page 10.

213 *dividends on preferred stock*).[11] (Emphasis added). The problem with the Texas
214 approach is the mischaracterization of interest expense as a noncash item. Clearly,
215 interest expense is not a noncash expense, since there is a definite current cash outlay
216 obligation associated with the expense. The other expense items considered in Texas,
217 such as depreciation, amortization, deferred taxes and prepaid expenses are in fact
218 noncash expenses. The error occurs by including interest expense in a list of noncash
219 expenses, which results in an overstatement of cash working capital requirements.

220 **Q. What are your recommendations to the Commission regarding the cash working**
221 **capital calculations to be used?**

222 A. I recommend that the Commission continue its practice of excluding depreciation and
223 common dividends from the cash working capital calculations. Both of these items
224 represent the return of invested capital to the owners of the company. With respect to
225 depreciation, the capital markets are aware of the regulatory lag involved with
226 depreciation recoveries and have adjusted the cost of capital accordingly. With respect to
227 common equity, decisions about how and when profits are distributed to the owners of
228 the company are wholly within the purview of the owners themselves. They may choose
229 to pay dividends or they may choose not to pay dividends. Ratepayers should not be held
230 accountable for any acceleration or delay in the distribution of profits that result from
231 those decisions. Even though including common dividends in the calculations would
232 tend to lower the cash working capital allowance, I believe the Commission's policy of

[11] Texas Substantive Rules §25.231(c)(2)(B)(iii)(IV) (-a-) The lead-lag study will use the cash method; all non-cash items, including but not limited to depreciation, amortization, deferred taxes, prepaid items, and return (including interest on long-term debt and dividends on preferred stock), will not be considered.

233 excluding common dividends from the cash working capital calculations is the correct
234 approach.

235 With respect to interest expense on long-term debt, I recommend the Commission re-
236 examine its treatment of this item. Clearly, interest is a cash expense. The ratemaking
237 formula provides for the recovery of interest costs from the ratepayers through rates and
238 the Company has the use of these funds for an extended period of time before payments
239 are made to the debt holders. These debt payments are not discretionary payments but
240 instead are binding contractual obligations of the company. As such, funds collected to
241 pay interest expense provide a significant source of cash for use in the day to day
242 operations of the Company that should be reflected in the lead–lag analysis.

243 **IV. O&M EXPENSE ESCALATION**

244 **Q. What is the Company requesting with respect to future O&M Expenses?**

245 A. Company witness Steven McDougal proposes an increase based on the Company's
246 projected O&M expense escalation. The forecasted 2012 test year includes an
247 adjustment to non-labor, and non-fuel expenses for projected price changes from the June
248 2010 test year to the June 2012 forecast test year, resulting in a proposed increase of
249 $7,529,903 over the annualized June 2010 expenses level. RMP arrives at this proposed
250 increase by applying IHS Global Insight indices to current cost levels for materials and
251 services.

252 **Q. Did you find it necessary to revise the Company's proposed O&M Escalation**
253 **Adjustment?**

254 A. Yes. The Company's O&M Expense Escalation Adjustment attempts to set rates based
255 on predicted inflation for the year 2012, but fails to take into account projected
256 productivity gains for the same time period. I believe that if the Commission allows an
257 escalation adjustment for a 24-month period beyond the test year, the escalation
258 adjustment should be offset by a projected efficiency savings adjustment. I have
259 recommended an offset to reflect projected annual efficiency savings of 0.5% per year.
260 Since the Company has requested a 24-month escalation period beyond the base year, the
261 efficiency savings adjustment offset for that two year period is 1.0%.

262 **Q. How does this estimate compare with the Company's O&M Escalation Expense**
263 **Adjustment?**

264 A. My adjustment, like the Company's adjustment, is comprised of two parts: Part One
265 addresses the direct assignment of projected future O&M inflation, and Part Two
266 addresses the system-wide O&M costs which are allocated to the various jurisdictions.
267 My adjustment reduces the Company's estimated O&M cost by $1,929,236 Utah
268 allocated and 4,729,424 Total Company.

269 **Q. Is there precedent for including efficiency savings offsets of this type?**

270 A. Yes. In California, where PacifiCorp has received authority from the California
271 Commission to use a post-test year ratemaking adjustment which would allow PacifiCorp
272 to recover cost increases that occur in future periods, the California Commission
273 approved an adjustment mechanism similar to my recommendation that provides for a
274 productivity offset of 0.5% to the consumer price index increase. From a ratemaking
275 perspective, when a projected inflationary adjustment is used for setting rates, that

276 adjustment should incorporate a productivity adjustment offset. By doing so, the
277 Commission provides the Company an incentive to aggressively contain O&M costs, and
278 more appropriately balances both the projected increases and the projected decreases
279 expected in future periods.

280 **V. PAYROLL AND RELATED EXPENSES**

281 **Q. Please describe the Company's payroll expenses and the adjustments related to**
282 **these costs?**

283 A. Payroll and payroll-related costs are the second largest category of expenses in the
284 revenue requirement after net power costs. Rocky Mountain Power is proposing to
285 recover nearly $218 million from Utah ratepayers for labor expenses, benefits and payroll
286 taxes.[12] This amount includes the June 2010 wages, incentives, benefits, retirement plan
287 expenses, and payroll taxes. It also includes adjustments for collective bargaining labor
288 increases, planned increases for non-bargaining labor, and budgeted levels of incentive
289 payments and benefit costs.[13] The two Company witnesses that sponsor testimony
290 related to payroll costs are Steven R. McDougal and Eric D. Wilson. Mr. McDougal's
291 testimony discusses the calculation of the adjustments to payroll related costs[14] and Mr.
292 Wilson's testimony discusses the Company's compensation philosophy and supports the
293 level of compensation included in the rate case.[15]

294 **Q. Please discuss the Company's justification for the level of compensation provided to**
295 **employees.**

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[12] See SRM-3, Page 4.16.2. $520 million multiplied by the Utah labor factor of 41.874% from R746-700-22.D.25-c.
[13] McDougal direct at lines 1051-1057.
[14] McDougal direct at 1051 – 1070.
[15] Wilson direct at 27 – 34.

296 A. Mr. Wilson testifies that test year payroll levels in this rate case are less than 1% more
297 than the levels requested in the last rate case, and this is the result of reduced salary
298 increases for employees.[16] Mr. Wilson's testimony and data as presented are not
299 completely accurate. For his comparison, Mr. Wilson starts with projected payroll costs
300 for June 2010, from the last rate case, of $515,965,330. However, actual payroll costs for
301 that period turned out to be only $485,175,759,[17] which is over $30 million less than the
302 Company's projected increase. In other words, the Company overestimated its projected
303 payroll cost for the previous test year by over 6%.

304 **Q. What would cause an over-estimation of this magnitude?**

305 A. The Company admitted that lower pay raises were awarded during the base year because
306 of the recession,[18] but that should have been known when the case was being prepared.
307 Another possibility is that the Company's projections, in the last case, ignored the
308 offsetting benefits associated with productivity gains.

309 **Q. In this case, what is the Company's projected payroll increase based upon?**

310 A. PacifiCorp based its proposed wage increases on collective bargaining contracts, actual
311 increases and planned increases. For the escalation factors in the rate case, the Company
312 surveyed several public utilities regarding merit raise expectations.[19]

313 **Q. Are there other payroll-related factors that could offset the Company's proposed**
314 **salary increases that have not been taken into consideration by the Company?**

[16]Wilson direct at 39 – 42.
[17] SRM-3, Page 4.16.2.
[18] See Wilson direct at lines 46 – 54.
[19] See the response to DPU 26.24.

315 A. Yes. While it may seem reasonable that pay raises implemented after the base year would
316 cause an increase in overall payroll expense, other events over the same period could
317 significantly offset this increase. For example, even with a stable workforce, employees
318 are being added to, and taken off of, the payroll registers on a fairly regular basis. Since
319 retiring employees are generally paid much more than new hires, overall payroll expense
320 levels can decrease significantly if a number of higher paid employees leaving the
321 company are replaced with employees paid at lower levels, or are not replaced at all.

322 Moreover, most businesses are generally able to improve the effectiveness of their
323 work force over time, resulting in increased productivity. Improvements in technology
324 and sound management practices can increase the productivity of a work force. These
325 improvements in productivity are generally rewarded through annual merit increases.
326 With improved performance comes increased efficiency. In effect, employees with
327 experience become better at what they do. This translates into a higher quality work
328 product produced in a shorter amount of time. Merit raises and increased productivity
329 generally go hand in hand. In short, it is inappropriate for ratemaking purposes to assume
330 that prospective payroll levels will increase by the amount of an anticipated pay raise,
331 when there are many other factors that could also impact overall payroll expense.

332 **Q. Mr. Wilson presented a table at the top of the third page of his testimony which**
333 **indicates that RMP has achieved a decrease in labor cost per KWh. Do you agree**
334 **with that conclusion?**

335 A. No. As discussed earlier, in his table, Mr. Wilson is comparing the last rate case
336 projection to the projection included in this rate case. In effect, he is comparing an

337 erroneous projection from the last case to the current case projection, which provides no
338 measure of productivity at all. When the actual June 2010 wage and benefits expense is
339 substituted for the prior case projection it shows that the Company is proposing to
340 increase wages and benefits in this case by 7.18%, not 0.88%, resulting in higher costs on
341 a per MWH basis. A corrected version of Mr. Wilson's table with the actual June 2010
342 wage and benefit cost substituted for the prior rate case projection is set forth below:

	12 Months Ending June 2012	12 Months Ending June 2010	Change
Wage and Benefit Expense	$ 520,029,165	$ 485,175,759	7.18%
Total Load – MWH	61,585,034	58,162,439	5.88%
$/MWH	$ 8.44	$ 8.34	1.23%

343

344 **Q. Is there evidence that productivity improvements are generally sufficient to**
345 **significantly offset pay increases?**
346 A. Yes, there is. The Bureau of Labor Statistics publishes employment cost data including
347 productivity information. The most recent release of 2011 1st quarter data indicates that
348 the manufacturing sector experienced productivity improvements of 4.7% in the last four
349 quarters. This compares to an annual average improvement of 3% from 2000 through
350 2009.[20]

[20] Bureau of Labor Statistics, News Release: Productivity and Costs, First Quarter 2011, Preliminary, 5/5/11.

351 **Q. Based on this information, what productivity adjustment should be considered in**
352 **this case?**
353 A. In my opinion, it would be appropriate to use the nine-year average long-term
354 productivity gains of 3% achieved by the manufacturing industry as a whole. This is well
355 below the 4.7% level that manufacturing achieved within the last year. A 3%
356 productivity adjustment would decrease RMP's payroll expense by $4,130,268[21] per year
357 or $8,260,535 for the two year projected period.
358 **Q. Have other utility commissions considered adjustments to recognize productivity**
359 **improvements?**
360 A. Yes. In its 2009 California rate case, PacifiCorp included a productivity adjustment of
361 0.5% of <u>revenues</u>, which is a fairly large adjustment, considering that the adjustment is
362 applied to revenues rather than to a single expense item such as payroll. Similarly, the
363 policy panel at the New York commission has proposed a labor productivity adjustment
364 of 2% in two separate cases. More importantly, this Commission recognized the need to
365 consider productivity improvements in Docket No. 07-035-93 as follows:

366 We concur with the Division a forecast test period, unlike an historic test
367 period, <u>must take labor productivity increases and other efficiency gains</u>
368 <u>into account in the determination of the revenue requirement.</u> In this case
369 we acknowledge the Company's automated meter reading program will
370 increase productivity in the test period. In this docket, we make no further
371 adjustment for productivity beyond what is incorporated by the
372 Company's projections. Further, it is our expectation the Company will
373 continue to look for ways to increase productivity and efficiency in the
374 future.[22] (Emphasis added).

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[21] $474,780,327*3%*69.25%*41.874%=$4,130,268.
[22] Errata Order, Docket 07-035-93, page 73.

375 In that docket, the Commission acknowledged the need for a productivity adjustment
376 when a forecast test period is used, but substituted the Company's significant adjustment
377 for meter reading savings. In this docket, however, the Company's automated meter
378 reading program payroll cost adjustment amounts to only $307,448, which is far below
379 the productivity improvements that should be obtained relative to the payroll levels
380 requested in this docket.

381 **Q. Please summarize your recommendations regarding the company's payroll cost**
382 **adjustment?**

383 A. The Company has considered only a single element of payroll costs in its proposed
384 payroll adjustment: pay increases. The Company, however, failed to consider an
385 adjustment for the levels of productivity improvements that should also be attained
386 during this same period. I recommend that productivity savings be shared with the
387 Company by offsetting payroll increases with a simple average 1.5% per year
388 productivity adjustment less the payroll component of the automated meter reading
389 adjustment. I recommend an adjustment to reduce payroll expenses by $9,556,113[23] on a
390 total Company basis and $3,822,820[24] to the Utah jurisdiction. Requiring the Company
391 to recognize productivity gains should be a requirement when a future test year is
392 utilized, as recognized by this Commission in its prior order. Moreover, it is particularly
393 imperative to incorporate productivity gains in prospective rates at this time in light of the
394 current economic hardships many ratepayers now face.

[23] ($474,780,327*3%*69.25%)-$307,448=$9,556,113.
[24] ($474,780,327*3%*69.25%*41.874%)-$307,448=$3,822,820.

395 ## VI. INCENTIVE COMPENSATION

396 **Q. Have you reviewed the level of incentive compensation expense the Company has**
397 **included in the current rate case?**

398 A. Yes. The Company seeks to include $33,719,000 on a total company basis in its payroll
399 projection.[25] This amount is based on "targeted" levels of incentive pay.

400 **Q. Please describe the Company's incentive compensation plan.**

401 A. The Company provided a copy of its 2011 Annual Incentive Plan. The stated objectives
402 of the plan are as follows:

403 PacifiCorp's Annual Incentive Plan provides performance awards
404 based on the following: achieving the goals of PacifiCorp, Pacific
405 Power, Rocky Mountain Power and PacifiCorp Energy; individual
406 performance; company management of risk and safety; and success
407 in addressing new issues and opportunities that may arise during
408 the course of the year. Awards will be made based upon
409 measurable achievement of results. Achievement will be measured
410 by senior management. This approach supports the philosophy of
411 incentive compensation as pay at risk that is earned based on the
412 company, business unit and individual performance.[26]

413 The plan also sets forth the following four "Plan Components:"

414 - Incentive awards are structured to achieve a target incentive
415 payout. Target award percentages are based on job classification
416 derived from competitive market data.

417 - All participants will have an award opportunity based upon
418 company, business unit and individual performance as measured
419 and assessed by senior management.

420 - Company and business unit performance will be evaluated
421 based on meeting objectives established in operating and business
422 plans and the organization's success in responding to unexpected
423 events.

[25] SRM-3, Page 4.16.2
[26] Attach R746-700-22.D.25-d.

424 ● Any adjustments for individual performance will be
425 reviewed by each president (business unit leader) and a final
426 decision made in collaboration with senior management prior to
427 final award determination.[27]

428 **Q. From the information provided, were you able to determine how PacifiCorp's**
429 **incentive plans are triggered?**

430 A. Based upon this summary of the overarching incentive plan, incentive compensation
431 payments appear to be based solely on the discretion of senior management, and the
432 criteria that senior management will use to assess employee performance are not clearly
433 defined. When incentive plans are designed in this manner, regulatory oversight of the
434 actual performance awards included in rates is particularly important.

435 **Q. Has the Company consistently paid the target level of incentives to employees?**

436 A: No. The Company's requested level of incentive pay in this proceeding is based on
437 "targeted" levels, but the Company's actual incentive payouts over the past several years,
438 on average, have been considerably lower than the targeted levels. The response to DPU
439 22.14 indicates that the Company did not pay the full target level of incentives in the two
440 most recent plan years, 2009 and 2010. The information provided in response to DPU
441 22.14 is as follows:

Plan Year	Total Base Compensation	Total Target Incentive Compensation at 100%	Total Target Incentive Compensation at 85%	Total Actual Incentive Compensation
2008	$192,941,486	$28,606,507	$28,606,507	$29,255,954
2009	$215,441,195	$37,701,780	$32,046,513	$28,666,705
2010	$218,598,646	$32,023,971	$27,220,375	$28,603,926

[27] Attach R746-700-22.D.25-d.

442 The only year, over the past three years, when the Company achieved its targeted payout
443 level was 2008, when the targeted level was less than $30 million. In reality, the
444 Company has been more consistent in the actual amount of incentives it pays each year
445 than it has been with achieving its targeted levels.

446 **Q. Does the Company have a motivation to pay out less than its target level for**
447 **incentives?**

448 A. Yes. When rates are set based on targeted levels, and the actual payments turn out to be
449 less than the amount included in rates, the difference is retained by the Company and its
450 shareholders.

451 **Q. Do you believe the target level for incentives is a reliable level for setting rates?**

452 A. No. The data above make it clear that the Company does not necessarily payout its
453 targeted level for incentives, making the targeted level an unreliable basis for setting
454 rates. Instead, in my opinion, the amount included in rates should reflect the Company's
455 actual payout experience over the past several years.

456 **Q. What is your recommendation regarding incentive compensation expenses?**

457 A. I recommend that the actual payment performance of the Company be taken into
458 consideration in setting the level of incentive compensation in rates. I recommend that
459 the level of incentives be limited to the average of actual payments for the 2008 through
460 the 2010 plan years, or $28,842,195 based on the information provided in response to
461 DPU 22.14 discussed above.[28] This results in an adjustment to reduce the requested level

[28] ($29,255,954 + $28,666,705 + $28,603,926) / 3 = $28,842,195.

462 of incentive payments by $4,876,805[29] and a reduction to the requested level of Utah
463 expenses of $1,414,163.[30]

464 **VII. MEDICAL EXPENSE**

465 **Q. What is the Company requesting with respect to future medical costs?**

466 A. The Company's forecasted 2012 test year includes $61,534,879 for Medical Plan
467 expenses. This is an increase of $7,765,530 over the annualized June 2010 expense level
468 of $53,769,349. This represents an increase of 14.44% for the 24-month forecast period,
469 or 7.22% annually. In support of its requested increase the Company cites a significant
470 upward trend in healthcare costs in recent years and references a statement from its
471 consultant, AONHewitt, that current trends show rates for the Company's medical
472 benefits are anticipated to increase further in 2011 and 2012.

473 **Q. Are you aware of other professional consulting firms that provide health care cost**
474 **information that differs in the forecast of health care cost trends?**

475 A. Yes. Towers Watson also provides information concerning health care costs estimates.
476 In its 2011 Health Care Cost Survey, Towers Watson states that health care cost for U.S.
477 employers will increase on average by 6.34% in 2011. The report states that the health
478 care cost estimates for 2011 are the result of employer efforts to aggressively manage
479 benefit program performance. Towers Watson also reports that health care cost have
480 reached a plateau of between 6% and 7% over the past few years.

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[29] $28,842,195-33,719,000=-$4,876,805.
[30] -$4,876,805*69.25%*41.874%=-$1,414,163.

481 Milliman, an actuarial and consulting firm, had similar findings in a recent
482 research report. The Milliman report indicates that the annual employer medical costs
483 were up 6.0% in 2011.

484 **Q. What is the Division's projected dollar amount for the Company's 2012 medical**
485 **expense?**

486 A. The Division's June 2012 projection for the Company's 2012 Medical Plan costs is
487 $61,061,090. This is an increase of $7,291,742 or 13.56% for the 24 month forecast, or
488 6.78% annually. This projection is based upon the average of the Towers Watson 2011
489 projected employer cost of 6.34% and the Company's estimated projection of 7.22%.

490 **Q. What is the basis of using the annual average of the Towers Watson Survey 6.34%**
491 **and the Company's supplied 7.22%?**

492 A. In Docket No. 07-035-93 the Commission accepted a similar approach stating that
493 "predicting health care costs is a difficult undertaking." The Commission in that
494 proceeding found it reasonable to take this balanced approach. I believe that by taking
495 this approach the Commission has given the company an increased incentive to
496 aggressively pursue medical cost containment.

497 **Q. What is the amount of your proposed adjustment?**

498 A. This adjustment reduces operating expenses by $473,789 on a Total Company basis, and
499 by $198,393 at the Utah jurisdictional level.

VIII. INSURANCE EXPENSE

500 **Q. Please discuss the Company's adjustments to insurance expense.**

501 A. The Company is ending its captive insurance program and is moving to self-insurance
502 using higher deductibles.[31] The captive insurance program's premiums had been frozen
503 as a result of agreements with various states related to the acquisition of PacifiCorp by
504 MEHC. However, as those agreements have expired, the Company has proposed to
505 become self-insured through the use of higher deductibles. The Company's proposed
506 adjustments in this case result in a net increase to total O&M expenses composed of an
507 increase to liability insurance, a decrease to property insurance, and an increase to
508 maintenance expenses. The Company's proposal normalizes these expenses by using a
509 three-year historic average of Property Insurance Expense, Injuries and Damages
510 Expense, and related maintenance expense.

511 **Q. Please discuss your recommendations related to these adjustments.**

512 A. I reviewed the Company's adjustments and supplemental data provided with the filing
513 and the Company's responses to data requests. The three year average methodology
514 utilized by the Company was consistently applied for the three components of the
515 adjustment consisting of Property Insurance Expense, Injuries and Damages Expense,
516 and the related repair and maintenance expenses. The Company's approach seems
517 reasonable under the circumstances. However, if the Company's proposed methodology
518 is utilized here, it should also be used in future rate case proceedings for consistency.

519 **IX. CONCLUSION**

520 **Q. Does this complete your testimony?**

521 A. Yes, it does.

[31] See McDougal direct at lines 505 – 612 and SRM-3 pages 4.11 – 4.11.5.