BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF THE APPLICATION OF QUESTAR GAS COMPANY FOR AN INCREASE IN RATES AND CHARGES	**DOCKET 02-057-02** **EXHIBIT NO. DPU 5.0** **PREFILED DIRECT TESTIMONY** **OF** **PAUL F. MECHAM**

FOR THE DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE
STATE OF UTAH

AUGUST 28, 2002

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Direct Testimony – Paul F. Mecham

Q. Please state your name and business affiliation

A. My name is Paul F. Mecham. I am employed by the Utah Division of Public Utilities (Division) as an Analyst in the Customer Services Section.

Q. What are your current responsibilities?

A. To prepare analyses and research of issues and utility functional areas to determine the potential benefits to companies and ratepayers. To coordinate and monitor consultants' analysis work. To monitor utility compliance with state laws and Public Service Commission (Commission) rules, regulations and orders.

Q. What is your experience and educational background?

A. I have 16 years experience in the public sector in management and personnel and 16 years in the Division working with utilities. I have testified in several dockets on compensation and other matters. I have a Masters Degree in Management from the University of Southern California.

Q. What is the purpose of your testimony?

A. I reviewed Questar's incentive compensation plans and recommend adjustments to revenue requirement which disallow rate recovery of costs that benefit stockholders and allow costs that benefit ratepayers to be recovered from ratepayers.

Incentive Compensation

Q. What is your opinion on Questar management using incentive compensation?

A. It is properly a part of management's prerogative to use this and other tools to motivate employees.

Q. What then is the issue?

A. The open question continues to be what portion of the cost for incentive compensation should appropriately be passed on to ratepayers through rates.

<u>Past Commission Orders</u>

Q. What has the Commission said on this issue in past dockets?

A. The Commission has been plain and consistent in limiting cost recovery from ratepayers to those which specifically benefit ratepayers. They have denied recovery for all other incentive compensation costs, particularly those tied to financial benefits and goals, below the line.

Q. What did the Commission find in Docket No. 93-057-01 that you believe to be most applicable to this docket?

A. The Commission findings that apply most directly to this Docket are as follows:

<u>Plan design and goals determine recoverability in rates</u>

> "... To determine program expenses that are properly recoverable in rates, we therefore must address incentive compensation plan design. Our concerns center on the choice of appropriate goals and whether employee awards should be based on outcomes outside their control. ..."[1]

<u>Ratepayer benefit is required</u>

> "Our policy has been to disallow recovery of expenses associated with financial goals where no credible link to ratepayer benefit is established. There is no apparent disagreement with this policy. Witnesses have quoted it in testimony and have agreed that the plan should benefit both ratepayers and shareholders. Therefore, the question is whether Mountain Fuel has established this link. We agree with the Division and the Committee that it has not done so. The record contains subjective assertion, not quantitative demonstration. We have consistently rejected this and will do so again here. We find that incentive compensation expense associated with the attainment of purely financial goals should not be recovered in rates....[2]

<u>Based on Employee Performance</u>

> ATo be acceptable for ratemaking purposes, we find that an incentive plan should be based on employee performance alone.@[3]

<u>Purely financial goals disallowed</u>

> AWe find that incentive compensation expense associated with the attainment of purely financial goals should not be recovered in rates.@[4]

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[1]Commission Report and Order in Docket No. 93-057-01, page 41, lines 15 - 19
[2]Ibid, page 44, line 25 - page 45, line 10.
[3]Ibid, page 46, line 25 - page 47, line 2

<u>Customer Service and Productivity only</u>

AThe Company is accruing . . . for the 1993 expense of the three operating goals it expects will be attained. But we permit recovery only for the productivity and the customer service goals. . . .@[5]

<u>Customer Service and Productivity linked</u>

AThe two remaining goals are customer service, measured by surveys of customer satisfaction, and productivity, measured by the number of customers per employee. The Committee argued that in a proper plan these goals would be linked so that both must be attained before payout for either occurs. . . .We see no credible objection, even by the company, and therefore find that the two goals should be linked ...@[6]

<u>Discretionary overheads rejected</u>

A. . . the Company increased the payout amount by approximately 17 percent to account for overheads. These include FICA, unemployment insurance, workmen=s compensation, general public liability insurance, pension plan, and stock plan. Mr. Mecham argued that, of these, only the first three, totaling 8.5%, are required by federal and state law, and are therefore a warranted addition to base pay. The last three are discretionary and should be rejected. . . . We find that these proposed modifications are reasonable and will adopt them for the purposes of this adjustment.@[7]

<u>Questar AMIP</u>

AMountain Fuel proposed recovery of $235,182 allocated to it, using the Distrigas formula, for Questar Corporation=s Annual Management Incentive Plan. This plan rewards officers and key employees for attainment of Questar Corporation financial goals. It is not independent of factors beyond employee control, such as weather. After due consideration, we disallowed such expense in item II.D.r.a., No new argument or issues are raised here. Consistent with our previous decision, we will not permit recovery of the proposed $235,182.@[8]

<u>Benefits go to shareholders by default</u>

AWe will be guided by the uncontested fact that any amount permitted in rates but not paid to employees for meeting goals will go, other things being equal, to shareholders.@[9]

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[4]Ibid, page 45, lines 8 - 10
[5]Ibid, page 51, lines 15 - 18
[6]Ibid, page 45, lines 22 - 26 and page 46, lines 17 - 19
[7]Ibid, page 48, line 24 - page 49, line 10
[8]Ibid, page 54, lines 14-22
[9]Ibid, page 42, lines 22 - 24

<u>Some plan expenses recoverable</u>

> "... we have suggested changes to alter the plan to reflect ratepayers' and we believe it is better public policy to recognize that ratepayers have a direct interest in the performance of utility employees. A more effective utility is beneficial to ratepayers, and incentive compensation is a good way to motivate superior performance. To reject all plan expense could be interpreted as a denial of this unobjectionable premise and a shirking of regulatory responsibility. We therefore conclude that some plan expense should be recoverable in rates. ..."[10]

<u>Summary</u>

> "To summarize, our policy has been to allow recovery of expenses if ratepayer benefit is demonstrated, and is not merely conjectural. We reaffirm this policy here and disallow expenses for financial goals and the net income trigger. We also eliminate the expenses of the load-building sales goal, because net ratepayer benefit has not been shown. We authorize recovery of payouts only for results achieved by employee efforts, and we disallow anything for the influence of extraneous factors like weather. To these alterations in plan design, we add that the recoverable expense must depend on the applicable portion of total base pay only. We permit an adjustment for overhead of 8.5 percent. ..."[11]

Q. What did the Commission say in its order in Docket No. 95-057-02 that may be applicable to this docket?

A. The Commission referred to testimony of various witnesses about the incentive plans being improved significantly, particularly in removing the Net Income "Trigger." However, the incentive issue, along with other revenue requirement issues were part of the stipulated settlement in that case. The Commission made no new findings or policy statements on incentive compensation.

Q. What did the Commission say in its order in Docket No. 99-057-20 that may be applicable to this docket?

A. The Commission referred to testimony of various witnesses about the incentive plans. The incentive issue, however, was again part of the stipulation in that case. The Commission made no new findings or policy statements on incentive compensation.

Q. Has the Utah Supreme Court addressed the issue of Commission orders applying to subsequent cases?

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[10] Ibid, page 50, lines 16 - 24
[11] Ibid, page 50, lines 1 - 11

A. Yes. Pages 9 through 14 of the final order on the "Charitable Contributions" case, 900020 by the Supreme Court of the State of Utah contained the following:

> "... when the Commission rules in a rate proceeding that, as a matter of law, certain categories of expenses cannot be charged to ratepayers, that ruling establishes law that controls future cases, subject to the Commission's power to reverse itself in an appropriate manner. ...
>
> "... In short, a rule of law announced in a decision of the Commission is as binding on a utility as a rule formally promulgated in a rule-making proceeding.
>
> "Mountain Bell never filed a petition asking the Commission to rule on the issue or to reconsider its 1969 ruling. In fact, Mountain Bell never directed the Commission's attention to the issue, and the Commission never addressed it. Under these circumstances, it cannot be said that the Commission intended to change a rule of law by silence. ...
>
> "Rate-making proceedings are not to be conducted on the basis of gamesmanship. The disclosure of charitable contribution expenses near the end of a multi-page exhibit attached to financial statements and under the general heading of "Miscellaneous" expenses does not comply with Mountain Bell's duty to petition the Commission to change its ruling on charitable contributions. Indeed, Mountain Bell's presentation of this expense was not in any way calculated to attract the attention of the Commission. As a party to the 1969 case, Mountain Bell must have known of the Commission's decision regarding charitable contributions. Despite its knowledge of that ruling, Mountain Bell simply disobeyed it."

Q. Has the Commission changed the positions it propounded in the 1993 Mountain Fuel Supply case cited earlier?

A. It has not.

Q. Is Questar aware of this Supreme Court order?

A. They are. I provided this same quote in my testimony in the Mountain Fuel Supply Docket, 95-057-02.

Q. What have Questar's actions been relative to the principles propounded by the Commission in Docket 93-057-01 and relative to the Utah Supreme Court, just cited?

A. In their filing in this case, they were silent on these issues. The Commission's attention was never directed to these issues. No petition has been raised with the Commission to change its rulings. We all must be vigilant in complying with the Commission's orders. One relatively minor but still positive exception to these negative observations is that Questar did remove AMIP costs from recovery from ratepayers.

<u>Questar History</u>

Q. Please list the significant changes relative to the above Commission findings in Questar's incentive compensation plans since the 1993 rate case.

A. The following actions were taken in the sequence listed. Because of the stipulations in the more recent Questar dockets, not all of these actions received reaction from the Division or other parties. Only the first two of those listed received endorsement from the Commission. Here are some highlights:

- Questar deleted the income trigger
- Questar added an O&M factor
- DPU commended Questar for the above actions in the 1995 case
- Because of the stipulation in the 1995 case, the Commission gave no additional guidance
- Questar deleted the O&M factor
- Questar added income (NOI) in under the "productivity" title (defined as NOI/employee)
- Because of the stipulation in the 1999 case, the Commission gave no additional guidance
- Questar added income in under the "Capital Productivity" title (defined as income/assets)
- Questar added income in under the "Operating Productivity" title (defined as income/employee)
- Questar has no quantifiable link between customer service and any kind of "productivity." In the 1993 rate case, productivity was defined as employees/customers. There currently is no mention of "customers" in any of Questar's "productivity" definitions.

Q. Do you have any comments relative to the Commission's observation on Questar having provided "...subjective assertions, not quantitative demonstration..."

A. Yes. Questar still provides no quantitative demonstration of direct ratepayer benefit. In their filing for this case, they provide no evidence of incentive compensation benefiting ratepayers. They even omit subjective assertions. They have used the word, productivity, which the Commission endorsed, but have removed customers from the definition. They removed the income trigger but income is now back in their goals. Safety is another problem word. On the one hand it is extremely important to a company handling natural gas. Questar's Customer Satisfaction Surveys continue to show customers' concern about safety. On the other hand, Questar's incentive compensation safety goals are defined on employee injuries and miles driven. The role of customers and natural gas have no bearing on the attainment of the safety goal. During informal discovery, there has been talk of the incentive compensation goals relating to customers and ratepayers. The Commission used the term, "link," to relate customer service and productivity (real, originally defined productivity). I believe an example of "link" would be to have customer service goals as triggers that must be met before other goals could be paid. This would really be a quantitative demonstration and not simply a subjective assertion. Questar's history and actions make it imperative that the Commission continue to look carefully at what really is behind the words that Questar uses.

Incentive Plans

Q. What incentive compensation plans does Questar have?

A. They have the following:

- PIPE, Performance Incentive Plan for Employees
- AMIP, Annual Management Incentive Plan
- LTSIP, Long Term Stock Incentive Plan
- Tickets
- Commendation Certificates
- Perquisites

<u>PIPE</u>

Q. Please describe PIPE including your recommendations.

A. PIPE is the Performance Incentive Plan for Employees of Questar Gas Company, Questar Pipeline Company, Questar Regulated Services Company and Questar Energy Services, Inc. It applies to employees of these companies other than those nominated to participate in AMIP (described later). The goals are:

Net Income
Safety
Customer Satisfaction
Capital Productivity
Operating Productivity

The following table summarizes these goals, their attributes, the percents asked for by Questar and the Division's recommendations. Each line entry has a brief explanation of the reasoning for disallowance which ties back to the Commission orders quoted earlier in this testimony. These explanations are adequate for those goals which are recommended to be totally disallowed. For the Safety and Customer Satisfaction goals, please refer the Question/Answer just before the Recommendation Summary on pages13 and 14 of this testimony.

Goals for PIPE	Maximum potential payout in the Plans	Questar asked for in this rate case	DPU recom-mended in this rate case
Net Income: This is a purely financial goal benefiting stock-holders exclusively	2.5%	0%	0%
Safety: This is <u>employee</u> safety based on injuries per 100 employees and accidents per million miles driven. It does not relate to customer safety. Ratepayer benefit is not identified. Handling natural gas is not mentioned.	1.5%	1.5%	1.0%
Customer Satisfaction: These measures are “muddied” with the involve-ment of QGC affiliates. It includes customers of affiliates. It considers affiliates to be customers. It does not apply exclusively to ratepayers	1.5%	1.5%	1.0%
Capital Productivity: This is <u>income</u> divided by assets. It has nothing to do with ratepayers.	1.5%	1.5%	0%
Operating Productivity: This is <u>income</u> divided by number of employees. It does not directly benefit ratepayers.	1.5%	1.5%	0%
Totals:	8.5%	6.0%	2.0%

Because actual payouts can vary due to performance and other factors, the Division based its analysis and recommendation on the percents at a maximum payout level. In the current case, Questar achieved all their goals and so the actuals in the above chart match the maximums. This is a coincidence that has not occurred frequently. Questar also recognized that the income goal does not match Commission criteria and has not asked for these costs to be recovered from ratepayers. This leaves the 6% Questar request for PIPE, of which the Division recommends allowing 2.0%. This is one third of Questar’s request. Therefore, The Division recommends disallowing two thirds or 66.67% of the request for PIPE. This recommended disallowance amounts to $1,468,317.

AMIP

Q. Please describe AMIP including your recommendations.

A. AMIP is the joint Annual Management Incentive Plan involving Questar Gas Company, Questar Pipeline Company, Questar Regulated Services Company and Questar Energy Services, Inc. It is for officers and key employees of these companies. The goals are:

Net Income
Safety
Customer Satisfaction
Capital Productivity
Operating Productivity

These goals are the same as for PIPE but have different weighting. They have the same shortcomings. They are significantly more financially oriented, ignoring the interests of ratepayers. The recipients are also significantly more organizationally isolated from ratepayers. Consistent with past Commission orders, as quoted on pages 3 and 4 of this testimony, the Division recommends full disallowance of AMIP. This recommended disallowance amounts to $396,117.

Miscellaneous Incentive Plans

Q. Please describe LTSIP including your recommendations.

A. LTSIP is the Long Term Stock Incentive Plan offering stock options to officers and key employees of Questar Gas. Questar has stated that there are no costs associated with this plan in this rate case. Had there been costs, the Division would have recommended disallowance due to being based on financial goals.

Q. Please describe the Ticket process including your recommendations.

A. Tickets to Jazz, Grizzlies, etc. sporting events are given to employees as recognition for special achievements. The Division believes that Questar did not adequately demonstrate a link to ratepayer benefit, however, it is not recommending disallowance at this time since the Commission has stated that ratepayers have a direct interest in performance of utility employees. This program is at the discretion of managers and could help motivate employees to better serve ratepayers.

Q. Please describe the Commendation Certificate process including your recommendations.

A. ROSE awards are Commendation Certificates given by managers and supervisors to recognize outstanding performance. The Division is not recommending disallowance. For the Division's reasoning, please refer to the comment above on tickets.

Q. Please describe the Perquisites including your recommendations.

A. Perquisites include only tax and financial and retirement planning. All officers are required to submit their tax returns to Ernst and Young for review for assurance that the officers are complying with tax laws and are not engaged in activities that could involve a conflict of interest. The Division is not recommending disallowance. For the Division's reasoning, please refer to the comment above on tickets.

<u>Payroll Overheads</u>

Q. Has Questar included payroll overheads in their incentive compensation request?

A. Yes.

Q. Please describe the overheads, including the Division's recommendation.

A. Questar provided the data in the left column below in a data response. These are the percents which Questar applied to the incentive compensation portion of its filing in this case. Data in the middle column below was calculated from labor-annualization data provided by Questar and reflects the actual percentages applied to routine payroll for the 12 month period ending December 2001. Note that three items (Medical/Dental Insurance, Life Insurance and Miscellaneous Overheads) have no bearing on this discussion and were excluded from the table below. Questar provided no explanation why the percents applied to incentive compensation are different from their normal practice. Data in the right column shows the Division's recommendation for inclusion in revenue requirement relative to incentive compensation:

Withholding Item	Questar Incentive Comp in this filing	Questar Routine Withhold for payroll	Division Recom-mendation
• FICA	7.65%	7.27%	7.27%
• Unemployment Insurance	0.14%	0.10%	0.10%
• Workers Compensation	0.52%	0.0%	0.52%
• Workers Comp & Gen'l Public Liability	0.0%	2.26%	0%
• Pension Plan	20.96%	18.80%	18.80%
• Stock (Employee Savings)	4.5%	3.93%	0.0%
• Total	33.77%	32.36%	26.69%

FICA, Unemployment Insurance and Workers Compensation are government mandated requirements and must be applied. In the 1993 Questar case, these were the only ones which the Commission allowed (per the quote earlier in this testimony). All other withholdings are made at the discretion of the Company. During the 1999 case, Questar assured the Division that there are government requirements that mandate pension withholdings, even on incentive compensation. Based upon that assurance, I recommend allowing pension withholding but at the lower rate that Questar applied to all withholdings during the year 2001. The Commission may want to have Questar confirm this requirement before it changes from the position it ordered in the 1993 case. Questar also indicated that there was Commission precedent that included pension withholding in a recent USWest docket. The difference between Questar's filing (33.77%) and the Division's recommendation (26.69%) is 7.08% of the incentive compensation in Questar's filing. The Division recommends a disallowance of this 7.08% amount. This recommended disallowance to Questar's filing amounts to $123,068.

Q. With the demonstrated flaws in Questar's incentive plans, why does the Division recommend allowance of any costs at all?

A. The flaws, running contrary to past Commission orders, might be justification for recommending total disallowance. On the other hand, the Division supports the

Commission's earlier comment that ratepayers have a direct interest in the performance of utility employees. The Division strongly encourages Questar to change their plan goals to reflect direct ratepayer benefit, particularly in the safety and productivity areas. The Division further hopes that these changes would be made in the enlightened interest in ratepaying customers.

Recommendation Summary

Q. When all of the above description and explanation of incentive compensation is combined with the dollars in Questar's filing, what is the dollar result?

A. The following table summarizes the Division's recommended adjustments. Note that all numbers come from 2001 and these amounts are assumed to not change during 2002. These are the numbers used by Questar in their filing. In response to a Division data request, Questar indicated that final 2002 numbers would not be available until February 2003. The following table summarizes the Division's recommended adjustments as applied to each separate test year.

Account	Questar Filing	Division Adjustment To Questar Filing
• PIPE Disallow 75% of payout (Exh QGC 4.4, Pg 20C, Ln 16)	$2,202,476	-$1,468,317
• AMIP Disallow All (Data Resp to DPU 4.2)	$396,117	-$396,117
• Incentive Compensation Overheads Disallow 7.08% of total AMIP and PIPE operating goals payouts ($1,738,251 QGC Exh 4.4, Pg 20C, Ln17)	$338,090	-$123,068
Total Recommended Adjustment		-$1,987,502

Q. Do you have any reservations or qualifications relative to these numbers?

A. Yes. I have used the very best numbers that I could extract from Questar's filing and data responses. If I have extracted an improper number or two, I welcome correction and update in follow-up testimony. I have no reservations or qualifications relative to the reasoning, conclusions and recommendations made.

Q. Is the Division against incentive compensation?

A. Absolutely not. As stated earlier, the Division believes that this tool is well within management's prerogatives. The Division is not trying to micromanage Questar's decision-making. It is merely attempting to assure the appropriate rate recovery of these expenses to ratepayers.

Q. Does that conclude your testimony?

A. Yes.