Short Term Incentive Program Issues for Pacific Gas and Electric Company Redacted Version

Prepared testimony of

John Sugar

JBS Energy, Inc.
311 D Street
West Sacramento
California, USA 95605
tel. 916.372.0534

prepared for

The Utility Reform Netwok (TURN)

CPUC
Docket #A. 12-11-009

May 17, 2013

Table of Contents

SB_GT&S_0501525

Tables and Figures

Tables

SB_GT&S_0501526

Short-Term Incentive Program

I. TURN's Goal

TURN's goal is to insure that PG&E's STIP incentives, paid using ratepayer funds, provide an incentive for PG&E employees to extend themselves in the interests of ratepayers. This is incentive pay, to motivate employees to "stretch" in performing their jobs. It is not simply an adder to salaries for everyone involved.

TURN Recommends:

Table 1: TURN STIP Recommendations

	PG&E 2012 STIP Program								
	PG&E Target Forecast			TURN Target Recommendation			Difference PG&E>TURN		
STIP Component	2012	2013	2014	2012	2013	2014	2012	2013	2014
Customer Satisfaction	$11,328	$11,684	$12,524	$0	$0	$0	$11,328	$11,684	$12,524
Financial Performance	$16,933	$17,252	$1,876	$0	$0	$0	$16,933	$17,252	$18,786
Net ESC Empl. STIP Partic.	$577	$1,122	$2,102	$0	$0	$0	$577	$1,122	$2,102
Total PG&E > TURN								$32,071	$35,426

This reflects TURN's analysis regarding the effectiveness of some STIP measures at encouraging employee efforts to benefit ratepayers. More generally, TURN has concerns regarding aspects of PG&E's STIP, discussed below, that compromise the overall value of the Program for motivating employee "stretch" efforts to benefit ratepayers.

For the program to be effective for ratepayers, employees must have a clear "line of sight", between their performance and impact on the incentive measure results. The measures of performance upon which STIP is based must also relate to ratepayer benefits. Finally, the levels of performance that employees must achieve to earn incentives must reflect a "reach", not be achievable unless employees are performing above a "normal" level.

II. PG&E's STIP Proposal

A. Background

TURN has concerns about the STIP that PG&E has redesigned for 2012. The STIP is a "one-size-fits-all plan. All STIP participating employees' STIP pay results largely from the work of employees in other areas. Unless an employee is in a business unit, or has responsibility that is directly related to some of the more specialized STIP measures, they can impact less than half of the weighted STIP criteria. The results for least one criterion, "Wires Down" appears to be heavily influenced by contractors rather than employees.

A number of the criteria or "measures" in PG&E's STIP are not good reflections of activities benefitting ratepayers. In particular, the Customer Satisfaction Score is not closely related to customer service, or benefits, that would generate customer satisfaction.

The "Earnings from Operations" measure could reflect benefits to ratepayers, as well as shareholders, if it used the commonly accepted definition of that financial measure. It does not use the common definition, but is open to PG&E's interpretation of financial performance.

Finally, for the largest single measure, "Earnings from Operations", the level of performance required to achieve the STIP is unknown to employees and to TURN. It is not only unclear what impact employee effort has on this malleable criterion. It is also not clear at what point employees have "stretched" their efforts enough to qualify for STIP rewards.

PG&E presents STIP, a variable incentive pay plan, as in important mechanism for attracting, retaining and motivating a qualified professional workforce. PG&E sees the plan as "generally more cost effective than a base-pay equivalent".

While this may be true of a well-designed plan, it is not necessarily the case. Edwin Lawler, Director of the Center for Effective Organizations at the University of Southern California wrote:

> "… a poor pay for performance system can cause counterproductive behavior, waste time, reduce trust, split an organization into warring factions and waste money. Having no pay for performance system is better than having a poor one."[1]

PG&E's 2012 STIP was designed within PG&E, by senior officers, representatives of HR, Finance, Internal Audit and the Board of Directors' Compensation Committee.[2]

The Board of Directors approved the Program.[3] TURN requested information on the Board's deliberations behind the Board's design decision. The redacted meeting minutes provided no information on the reasoning behind the choices of measures and target levels. An example is attached.[4]

B. Revised 2012 STIP Program

PG&E has modified its STIP Program for 2012, altering the criteria on which STIP-covered performance is based and adding classifications of employees that receive STIP-based compensation in place of some of their annual General Wage Increase (GWI).

PG&E's proposed STIP measures are a mix of measures, and include a nuclear plant performance indicator, a measure of customer perceptions and satisfaction, an indicator of return to shareholders, measures of gas distribution operations' performance, electric distribution operations' performance and measures of employee safety.

TURN supports using the measures of employee safety, the Lost Workday Case Rate and the Preventable Motor Vehicle Incident (MVI) Rate as measures that most or all employees can affect through their performance. These incent employees to exhibit

---

[1] "Pay for Performance, A Strategic Analysis", Edward E. Lawler, p. 3-179, in Compensation and Benefits, Luis R. Gomez-Mejia ed, The Bureau of National Affairs, Wash, D.C. 1989

[2] TURN DR 17-1

[3] TURN DR 17-3

[4] TURN 17-3 Atch1 Conf Redacted

desirable behavior, reducing PG&E's costs, and contributing to employee welfare. They constitute 16 percent of the STIP weighted measures.

Earnings from Operations is also a measure toward which all employees can contribute. While PG&E has reduced the weight of "Earnings from Operations" in the STIP payment calculation, it plays a large role in any individual employees' incentives. Decisions by each employee to improve efficiency and productivity should improve company performance, and the STIP score on which incentive payments are based. Each employee has less control over this measure than the STIP "Operational" measures.[5] However, the "Earnings from Operations" measure represents nearly half, to almost two-thirds of the weighted STIP measures that any one of the employees can affect.

TURN takes issue with the way PG&E intends to calculate this Measure, which we discuss later.

The other measures that PG&E includes in this version of STIP are impacted by subsets of employees. They do not provide a "line of sight and line of influence"[6] to STIP performance for the balance of employees in the short-term incentive program. It is not apparent to TURN, and likely these employees, how their actions can impact these contributing Measures of their STIP income. This "one size fits all" approach, compared to team performance measures related to the goals of a business unit, is not optimal for encouraging improved employee performance.[7] "Line of Sight" for employees, where they can see how their actions influence STIP measure results is important, to maintain employee satisfaction with the plan.[8]

---

[5] "Gainsharing or Profit Sharing", Robert Masternak, Pres. Masternak and Assoc, in The Compensation Handbook, Fifth Edition, Berger and Berger, McGraw Hill, 2008, p. 287

[6] Op Cit, Edward Lawler, p. 3-170

[7] "Using Variable Pay Programs to Support Organization Goals" Erin Packwood, Mercer Homan Capital, in Berger and Berger, p. 222

[8] "Incentive compensation Program Design, Linda Amusa, David Knopping, Radford Surveys and Consulting, in Berger and Berger, p. 210

1. Electric Distribution

In the Electric Distribution business unit, measures of SAIDI and 911 emergency response relate to staff efforts. These are indicators of benefits to ratepayers. Notably, much of the PG&E employee activities that impact these measures is done by represented employees, who are not eligible for STIP compensation.

"Wires Down" is a measure that reflects both PG&E employee and contractor involvement. In 2012, 40 percent of T&D "wires down" incidents were caused by vegetation, causing wires to go down. As PG&E notes, contractors are responsible for vegetation management patrols, with employees also responsible for noting potential vegetation issues. While employees have an unquantified role in PG&E's success in this measure, they are not entirely responsible.[9]

The Wires Down target appears to be a stretch goal, with a target of 1,611 in 2012. In 2012, excluding some major events, PG&E recorded 3,054 wires down, nearly 90 percent above the STIP target level. Reducing the number of wires down is an important goal for PG&E. That number's current application in STIP, with ambiguity about the potential for employee impact on a large number of measured wires down events, may be less effective than a Measure targeted strictly at incidents in which employees have a direct impact. Some employees could be responsible for encouraging more responsible effort by contractors. Others may be responsible for encouraging field crews to be more vigilant. If measures for these groups were specific to their duties, using this criterion could be more effective.

Managers and Supervisors of field Staff in Electric Distribution operations are somewhat able to affect:

Table 2: Electric Distribution-Related Measures

Measure	Weight
Trans. and Dist. Wires Down	4%
911 Emergency Response	4%

[9] TURN DR 38-9a-d

Lost Workday Case Rate	8%
Prev. Motor Vehicle Incident Rate	8%
SAIDI	10%
Earnings from Operations	**30%**
Total:	64%

2. Gas Distribution

In the Gas Distribution business unit, leak repair performance, gas emergency response and gas asset mapping relate directly to performance of staff in this business unit.

Supervisors of field staff in Gas Distribution operations are able to affect:

Table 3: Gas Distribution-Related Measures

Measure	Weight
Leak Repair Performance	4%
Gas Emergency Response	4%
Lost Workday Case Rate	8%
Preventable Motor Vehicle Incident Rate	8%
Gas Asset Mapping	10%
Earnings from Operations	**30%**
Total:	64%

3. Nuclear Operations

The Nuclear Generation business unit directly impacts Diablo units 1 and 2 performance against the Institute of Nuclear Power Operations Performance IndicatorsStaff in Nuclear Generation operations are able to affect:

Table 4: Nuclear Generation-Related Measures

Measure	Weight
INPO Performance Indicators	8%
Lost Workday Case Rate	8%
Preventable Motor Vehicle Incident Rate	8%
Earnings from Operations	**30%**
Total:	54%

4. Other Business Units

Staff in other business units, or staff in the above units whose diligence is not reflected in the indicators can impact:

Table 5: Other Business Unit-Related Measures

Measure	Weight
Lost Workday Case Rate	8%
Preventable Motor Vehicle Incident Rate	8%
Earnings from Operations	**30%**
Total:	46%

C. INPO Performance Measure

The INPO measures appear to be a good measure of the safe operation of Diablo Canyon. The Diablo Units have been improving their INPO scores since 2009.[10]

[redacted][11]

[redacted][12]

Nuclear plants are relatively isolated installations. Performance measures, other than generating performance, or personnel-related measures, are unlikely to be applicable to a broad range of employees outside of the plant. In this case, non-Diablo employees

---

[10] TURN DR 38-10

[11] [redacted]

[12] Op Cit, Lawler, p. 3-171

participating in STIP are unlikely to be familiar with the INPO criteria are, and have no opportunity to affect the INPO results. This would be the case for other generation-related employees responsible for hydro, fossil and renewable plant design or operation.

This Measure only may provide a "line of sight" and "line of influence" for nuclear generation employees, and those above the nuclear generation organization. It is a poor choice as a more general STIP measure of performance.

D. Customer Satisfaction

TURN does not believe that broadly defined "customer satisfaction" reflects benefits to ratepayers. Given the variety of factors that can affect customers' perception of utility performance, changes in customers' general "satisfaction" with the utility may reflect the result of careful packaging or messaging rather than improved utility service delivery. TURN's discussion considers the fact that the PG&E representatives who contact customers and affect their satisfaction are not part of STIP, that efforts to adjust customer contacts to improve satisfaction may have negative economic consequences, not understood by the majority of customers, and that image advertising rather then actual performance improvement can impact customer perceptions.

STIP participation does not extend to represented field employees, who are most likely to meet with customers to resolve problems, or to respond to customer calls. It also does not include customer service representatives, who are likewise PG&E's first line of customer contact, and responsible for many customers' perception of, and satisfaction with, PG&E. If they do a good job, managers, engineers, directors and others benefit from any improvement in customer satisfaction. The front line employees, however, do not have their performance rewarded from the program.

Unfortunately, there are activities that improve many customers' satisfaction, but may have adverse economic consequences for other customers. The Proactive Outage Notification Program proposal is such an initiative. In this program, PG&E proactively contacts customers in an area experiencing a power outage, and provides an estimate for restoration time. This can provide a significant improvement in customer satisfaction, if the outage does not extend beyond the forecast restoration time. In fact, the satisfaction score that customers gave to JD Powers were best when the restoration time was shorter than predicted.

As PG&E notes in its "June Customer Care Update", this result suggests that PG&E should tell customers a later time than they expect operationally to restore power.[13] While this may improve a customer's impression of PG&E's performance, it can prove problematic for business owners, and others making decisions based on the outage duration forecast in PG&E's proactive call.

If a business owner experiences an outage, he or she must decide whether to remain open until power is restored, or whether to close. This is especially important if employees are paid on an hourly basis. Staying open if business cannot be transacted or production is halted can be expensive. An accurate estimate of restoration time allows the business owner or manager to make an efficient decision. If the utility systematically overestimates the time until restoration, there is a greater likelihood that businesses will close, when a better decision might have been to remain open.

[redacted][14]

"Under-promising" when better information is available can reduce income for the PG&E business customer and its employees, with no real countervailing benefit. This would be a direct cost of currying customer satisfaction. The potential improvement in "satisfaction" for some customers comes at a cost to other customers.

If PG&E's STIP was not linked to such measures of customer satisfaction that are unrelated to actual performance, there may be less pressure to pursue measures such as actively delivering inaccurate information on expected power restoration times.

Image advertising, done properly, can have a major impact of public perceptions of satisfaction with an organization, or even a political candidate. It can reach a broad

---

[13] TURN DR3-1 Atch 10, p. 15

[14] [redacted]

range of customer across PG&E's service territory. In the absence of negative incidents that catch wide public attention, image advertising can significantly affect perceptions of satisfaction with the utility.

In a situation in which promotional advertising is used for "brand positioning", any satisfaction surveys must be carefully designed to determine customer "satisfaction" from performance, rather than "satisfaction", or warm feelings, based on image resulting from image advertising.

The CPUC does not allow rate recovery of the cost of image advertising. Until PG&E can demonstrate that any customer satisfaction score resulting from PG&E managed surveys reflect only improvements in direct customer benefits and do not reflect benefits tosome customers at the cost of others and feel good advertising, the Customer Satisfaction Score does not reflect actual customer benefits, and provides skewed incentives for manipulating customer perceptions.

A good impression of PG&E may benefit its investors. It does not benefit customers. This portion of the overall STIP score should be the responsibility of PG&E's shareholders, not ratepayers.

The STIP payments bypass most employees who deal with customers, Seeking ways to boost satisfaction of some customers can disadvantage other customers, and "satisfaction" perceptions are subject to many non-utility-performance factors.

TURN recommends excluding the Customer Satisfaction Score (weighted at 10% of STIP Measures) measure-related costs from ratepayer-funded STIP payments.

	Customer Satisfaction at Target Measure		
	2012	2013	2014
PG&E Forecast (without ESC employees)	$11,328	$11,684	$12,524
TURN Recommendation	$0	$0	$0

E. Financial Performance

The Financial Performance Measure of Earnings from Operations is the largest single measure that any one group of employees can impact. Ideally, this measure would be designed around the GAAP standardized measure of, "Earnings from Operations", upon which investors and financial firms rely in assessing the desirability of investing in or loaning to a firm.

As PG&E notes, PG&E's financial performance is an important consideration in the company's ability to raise capital at a competitive rate. The financial performance criterion in STIP helps focus employees on opportunities for operational efficiencies to decrease costs, improving affordability of PG&E services, and PG&E's access to and cost of capital and trade credit.[15] Investors and lenders compare companies' potential for providing a profitable, controlled risk investment based on various measures, including the standard GAAP "Earning from Operations"

This measure is not what PG&E proposes. PG&E proposes to use a modified "Earnings from Operations" measure in STIP, that excludes income or expenses associated with unusual events or circumstances that are "not part of ongoing core operations". This is not the measure on which financial markets focus. In fact, this revision can be used to create the appearance of better performance than PG&E must report to financial markets, thus showing better performance for purposes of STIP. PG&E does not tell us what income or expenses have been excluded. PG&E also does not reveal what the target is for this STIP Measure, nor the bottom or top limits on the range that STIP considers. PG&E states generally that Measure targets are set to "encourage stretch performance to accomplish key goals."[16] Here we have no idea if this is the case. In the past, the cost of the GEEM Program, incurred to remediate years of leak survey shortcomings, and the cost of the Proposition 16 campaign were scrubbed from the incentive program financial performance measure, providing much better incentive program results than would have otherwise been reported.[17] Meanwhile, in the outside financial world, these expenses were part of PG&E's reporting.

Shareholders benefit from reasonable earnings. Ratepayers benefit from a utility that is able to raise capital, as necessary, to fund investments in the system. Unfortunately, the

[15] TURN DR 38-2 b-c

[16] PG&E Exh. 8, p. 5-6

[17] CPUC A09-12-020, Policy and Results of Operations for Pacific Gas and Electric Company Public Redacted, William Marcus, TURN, May 19, 2010, p. 20-22

STIP Measure is unrelated to financial market perceptions of PG&E, but is rather a product of unspecified internal adjustments, measured against unknown goals.

Ratepayers do not benefit from this Measure. Especially concerning is that this is the largest single Measure that relates to any one group within PG&E, and it is unclear how employee efforts impact it, given the flexibility that PG&E gives itself in reporting results.

TURN believes that shareholders should pay this portion of STIP. They may benefit from employees seeking to perform well in this area.

	Earnings from Operations		
	2012	2013	2014
PG&E Forecast for Earnings from Ops. (without ESC Empl.)	$16,993	$17,525	$18,786
TURN Recommendation	$0	$0	$0

F. Replacing General Wage Increases with STIP

PG&E proposes to add almost 20 percent of its professional and technical (ESC bargaining group) employees to STIP, using the STIP income as replacement for a portion of the general wage increase for which the employees would otherwise be eligible.

It is not clear if this melding of reduced GWI with STIP mirrors the use of STIP with "full-fledged" STIP participants, who have their salary increases determined outside of labor agreements.

TURN has three concerns regarding this proposal. The first is the apparent lack of relationship between the employees' activities and STIP Measure outcomes. The second is the lack of explanation for offering these employees significantly larger potential annual increases than other employees in the same bargaining group, and the third is where PG&E plans to take the program during the attrition years. PG&E does not explain how the increases offered to the STIP eligible employees translate into a long-term relationship between these employees' compensation, and compensation for other ESC employees. Based on these concerns, TURN recommends denying funding for this effort.

1. Lack of Relationship Between Responsibilities and STIP Measures

PG&E's workpapers present the job titles that would be eligible for this STIP treatment. Some of the titles appear to relate to the Measures used to determine STIP performance. Positions such as civil engineer, maintenance and construction engineer, consulting engineer and project planner and control analyst may do work that has an impact on the 2012 STIP measures.

Other job titles that do not appear to relate to the STIP measures, at least in the short-term, include Land Planner, Right-of-Way Agent, Senior and Principal Land Agent, and Project Surveyor.

PG&E's proposal to make a portion of the ESC employees eligible for STIP payments runs the risk of driving a wedge between included and excluded ESC employees.[18] [19] If it were evident that all of the included classifications contributed to the STIP results, the reason for division between participants and non-participants might be clearer to all involved, including both STIP and non-STIP-eligible employees. This does not appear to be the case.

If income of incumbents in the unrelated positions is related to the currently proposed version of STIP, the incumbents are either penalized or rewarded for the work of others. The achievement of STIP goals is unrelated to their efforts. This does not meet PG&E's stated STIP purpose of "employ incentive pay at risk to motivate employee performance".[20]

Only the discretion that supervisors have to modify the STIP award, while remaining within their budgets, could provide an incentive related to these employees' performance. While this discretion is a part of STIP, in this case it is not related to the STIP goals that set the range of discretion. If PG&E is interested in pursuing that flexibility they should pursue it separately, without the unnecessary complication of

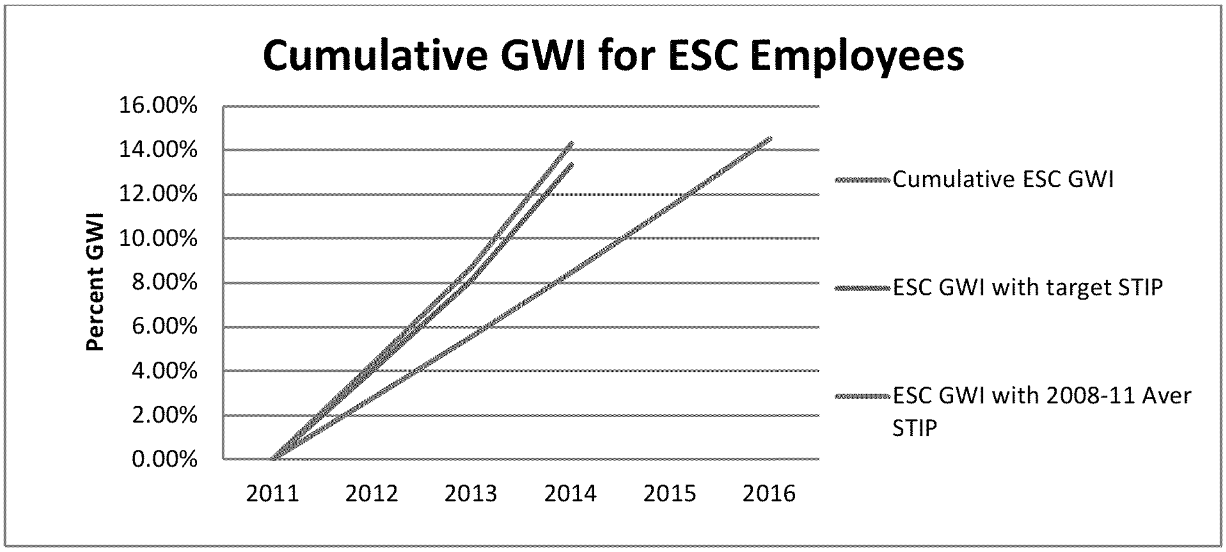
---

[18] Op cit. Masternak, p. 288

[19] Op cit. Lawler, p. 3-143

[20] PG&E Exh. 8, p. 5-7

STIP measures, and hopefully without as much largesse as the existing proposal appears to include.



21

2. STIP with GWI Increases May Result in Large Compensation Increases

If the STIP results are at target, or close to target, these select ESC employees' income will increase at a higher rate than their un-STIP eligible counterparts, and other represented employees. With STIP at target, between 2011 and 2014, the STIP-eligible employees would realize pay increases of 13.3 percent. With the average STIP score from 2008 through 2011, the pay increase would be 14.3 percent. Other ESC employees would have base pay increases of 8.5 percent.

3. Where does PG&E's Proposal go from 2014?

PG&E is not clear regarding its plans beyond 2014. If the STIP participation for these employees ends, does their compensation fall back to where the GWI increases of the non-STIP ESC employees would leave them? Do these employees remain at the higher compensation level and then earn the standard GWI increments? Do employees continue to receive reduced GWI increments with continued STIP participation?

---

21 TURN Excel Worksheet: "STIP Calcs".

PG&E doesn't say, and TURN doesn't know. It appears that if PG&E does not find a way to retain the higher pay levels for these employees, there is likely to be considerable disappointment and possibly disaffection. If PG&E ends the program, and leaves the employees at higher pay levels, ratepayers are paying more, without whatever incentive benefit the STIP portion provided.

TURN recommends denying funding for this proposal.

	Including ESC Empl. In STIP		
	2012	2013	2014
ESC Empl w/STIP: 2.75% Cost	$47,998	$49,318	$50,674
ESC Empl. w/ STIP -1%	$47,181	$47,652	$48,129
Payroll Savings	($817)	($1,666)	($2,545)
STIP Eligible ESC Empl. Payout	$1,394	$2,788	$4,647
Net Cost of STIP ESC Proposal	$577	$1,122	$2,102
TURN Recommendation		$0	$0 [22]

[22] PG&E Exh WP-8, p. 5-4