Company:	San Diego Gas & Electric Company (U902M) Southern California Gas Company (U904G)
Proceeding:	2016 General Rate Case
Application:	A.14-11-003/004 (cons.)
Exhibit:	SDG&E-242 SCG-241

SDG&E AND SOCALGAS

REBUTTAL TESTIMONY OF ROBERT SCHLAX

(FINANCIAL COMPONENTS OF SHORT TERM INCENTIVE COMPENSATION)

June 2015

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

A Sempra Energy utility

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SDG&E AND SOCALGAS REBUTTAL TESTIMONY OF ROBERT SCHLAX (FINANCIAL COMPONENTS OF SHORT TERM INCENTIVE COMPENSATION)

I. INTRODUCTION

The Utility Reform Network (TURN) issued its report on Incentive Compensation and Supplemental Pensions for Southern California Gas Company (SoCalGas) and San Diego Gas and Electric Company (SDG&E).[1] TURN argues that California ratepayers should not fund financial goal-based incentives in Variable Pay (also referred to as "ICP"), based in part on the following claims:

- TURN "believes that the Commission's decisions regarding the utilities' returns on equity, and resulting authorized revenue, should provide sufficient return from utility operations to keep Sempra Utilities 'financially strong.'"[2]
- TURN contends that SDG&E and SoCalGas provide no evidence that ratepayers benefit from Sempra Energy's or the utilities' financial performance that exceeds the utilities' authorized return on equity.[3]
- TURN believes that the financial goals in the ICP calculation are unrelated to most employees' performance.[4]
- TURN takes issue with the Sempra Energy Compensation Committee's discretion to exclude or include certain events in the financial goals calculation.[5]

SDG&E and SoCalGas believe TURN's arguments do not reflect an understanding of revenue requirement ratemaking, how financial performance metrics for the short-term incentive compensation plan (ICP) are determined annually and how achieving or exceeding target financial performance metrics benefits ratepayers. The following rebuttal will show that the financial goals included in the overall ICP are reasonable, necessary to maintain the financial well-being of SDG&E and SoCalGas and align with the best interests of ratepayers.

II. REBUTTAL TO TURN'S PROPOSALS

This rebuttal testimony is focused on the particular issues TURN raises regarding the financial goals component of the ICP performance metrics. For complete descriptions of the

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[1] Prepared testimony of John E. Sugar, on behalf of The Utility Reform Network dated May 15, 2015 (TURN Testimony (Sugar)) at 5-14.
[2] *Id.* at 7.
[3] *Id.* at 5.
[4] *Id.* at 7-9.
[5] *Id.* at 9-10.

SDG&E and SoCalGas proposals for ICP, please see the direct testimony of Debbie Robinson.[6] In particular, as Ms. Robinson stated in her direct testimony:

- The Total Compensation Study found SDG&E and SoCalGas' total compensation to be in line with the competitive market;[7]
- The elements of compensation analyzed in the Total Compensation Study included ICP awards as a component of SDG&E and SoCalGas' total compensation.
- SDG&E and SoCalGas' ICPs have historically included financial goals as one of the performance metrics in their ICP; and
- The Financial Goals component is but one portion of ICP performance metrics and the exclusion of one or more of the ICP performance metrics would be counter to the basis upon which the Total Compensation Study was conducted.

Therefore, while there may be differing opinions regarding which performance metrics should be included in the ICP (and the calculations of such performance metrics), what is of primary importance is ensuring that the total compensation of SDG&E and SoCalGas' employees, which includes ICP, is in line with the competitive market.[8] Without the ICP component of total compensation, SDG&E and SoCalGas employees may be financially compensated below market. And, as Ms. Robinson testifies, maintaining a market-competitive total compensation package is critical to attracting, motivating and retaining a skilled, high-performing workforce.[9] TURN's arguments may thus unintentionally encourage SDG&E and SoCalGas to provide higher base salaries in lieu of incentive compensation. As Ms. Robinson also notes, this result would not be beneficial to ratepayers, as these incentive programs encourage employees to continue to find opportunities to improve efficiency, safety, reliability and customer service.[10]

It is also important to note that the Commission explicitly rejected arguments to revise incentive compensation metrics, including financial metrics, in SDG&E and SoCalGas's last rate

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[6] SDG&E-22 and SCG-21 (Robinson).
[7] See SDG&E-22 and SCG-21, Attachment A, the Towers Watson Total Compensation Study performed under the direction of the Office of Ratepayer Advocates and Sempra Energy.
[8] Decision (D.) 92-12-057, D.04-07-022 and D.93-12-043, the Commission concluded that "… incentive pay is part and parcel of the overall compensation scheme," that "… the allocation of total cash compensation between salaries and incentives should be left to each utility's discretion." See SDG&E-22 and SCG-21 at DSR-8 through DSR-9.
[9] SDG&E-22 and SCG-21 (Robinson) at DSR-5 through DSR-13.
[10] SDG&E-222/SCG-221 (Robinson) at DSR-9 through DSR-10.

case, saying: "SDG&E and SoCalGas are in the best position to decide what [incentive compensation] metrics to use to measure the performance of its employees, and to revise the metrics as UCAN has suggested would result in the Commission's micromanaging of the Applicants' variable compensation." [11] Regarding financial metrics, the Commission agreed that ratepayers benefit from a financially strong utility, saying: "[t]he financial metric may benefit ratepayers as a result of the companies' lower borrowing costs,"[12] and "[a]s the Applicants point out, a financially strong company usually has lower borrowing costs, which benefits ratepayers by lowering costs."[13] TURN's arguments addressed below should be viewed in light of the Commission's strong affirmations in the last rate case allowing SDG&E and SoCalGas management to determine incentive compensation plan metrics, including financial metrics.

A. Ratepayer Benefit From Financial Performance Exceeding Authorized

The Commission sets rates based on the well-established principle that a "utility is entitled to all of its reasonable costs and expenses, as well as an opportunity to earn a rate of return on the utilities' rate base."[14] The simple revenue requirement ratemaking equation is:

Annual Revenue Requirement = Expenses + Cost of Capital

where included in expenses are operations and maintenance costs, and cost of capital includes interest payments to lenders plus a return on shareholder equity (a Commission-authorized return on equity multiplied by total equity). My rebuttal testimony supports a Commission determination on the reasonable "expenses" component of the equation – specifically, the reasonableness of SDG&E and SoCalGas' employee compensation. As TURN notes, the Commission determines SDG&E and SoCalGas' authorized return on equity in a separate proceeding.[15]

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[11] D.13-05-010 at 882.
[12] *Id*.
[13] *Id*. at 883.
[14] D.03-02-035; *see also* D.14-08-011, at 31 ("[T]he basic principle [of ratemaking] is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of the property devoted to public use[.]").
[15] See the Commission's Rate Case Plan, R.87-11-012, which established separate Commission proceedings on revenue requirement, cost of capital, and rates. For this reason, SDCAN's argument that the Commission should "reduce SDG&E earnings" and rates in this proceeding (Prepared Testimony of Michael Shames on behalf of SDCAN, May 15, 2015 at 8) is misplaced, as will be addressed in briefing. SDG&E's and SoCalGas' currently authorized return on equity was determined in D.12-12-034, as TURN notes, and SDG&E's rates will be determined in its GRC Phase 2 proceeding.

TURN argues that the Commission-authorized return on equity component in the above equation is all a utility needs to remain financially healthy, saying: "TURN believes that the Commission's decisions regarding the utilities' returns on equity, and resulting authorized revenue, should provide sufficient return from utility operations to keep Sempra Utilities "financially strong."[16] This opinion misses the point in this case. The above equation shows that a utility must be permitted the opportunity to recover its reasonable costs and expenses – as will be determined in this General Rate Case (GRC) – in order to remain financially healthy. Additionally, the investment community certainly notices whether a utility is allowed to recover its reasonable costs in rate case proceedings. Rate case decisions on revenue requirement can affect investor perception of a utility's creditworthiness, which is important to keeping the cost of utility debt low on behalf of customers.

Moreover, TURN's statement suggests a mistaken belief that a Commission-authorized rate of return on investment is guaranteed to be recovered in utility rates. As the Commission has stated, although "a utility is generally entitled to its reasonable costs and expenses," it is only offered "the opportunity, but no guarantee, to earn a rate of return on the utility's rate base."[17] This means that a utility must be well-managed in order to earn its authorized rate of return. Management decisions on incentive-based pay, including decisions on the type of incentivizing metrics needed in order for a utility to achieve its goals – whether safety, reliability, operational, or financial – are exactly the type of prudent management decisions that a utility must be able to make in order to remain operationally and financially healthy.

It is important to recognize that the financial targets set forth in the ICP are determined annually and are representative of achieving optimal financial results given the regulated environment in which SDG&E and SoCalGas operate. SDG&E's and SoCalGas's authorized return on equity (ROE), as determined in a Cost of Capital proceeding, only provides the basis upon which their annual authorized revenues are established, and does not ensure that either SDG&E's or SoCalGas' actual financial results will equate to achieving their respective authorized ROEs. For any given period, the actual financial results are subject to many different variables. Whether actual financial results are below, equal to, or above ICP financial target is dependent upon the impact of these variables and the responses of employees. Additionally, the

[16] TURN Testimony (Sugar) at 7.
[17] D.12-11-051 at 10.

Commission has recognized that utilities should be motivated to achieve operating efficiencies to reduce costs.[18] These efficiencies may contribute to earnings above the authorized return in a given year, but also benefit ratepayers because: (1) a financially healthy utility is able to acquire low-cost debt and shoulder financial risk, and (2) efficiency cost savings are passed on to ratepayers in future rate cases. These factors are considered when ICP financial performance metrics are established.

As previously mentioned, ICP financial performance metrics are determined annually and the targets are not established based on authorized ROE. The ICP targets are based on financial targets which are approved by the respective company's management and provided to financial analysts during the utilities' annual Analyst Conferences. By establishing metrics based on the annual financial targets, financial goals include the forecasted impacts of key initiatives and known variables that result in either SDG&E or SoCalGas achieving financial results above or below the authorized ROEs.

In addition, a large portion of information considered in GRCs includes historical operating expenses. To the extent that SDG&E and SoCalGas achieve optimal financial results due to operating efficiencies (actual expenses being lower than expected), these efficiencies would be reflected in the historical expenses being assessed in future general rate cases and thus benefit ratepayers in the future.

As mentioned in Debbie Robinson's direct testimony,[19] we are "requesting recovery of ICP expenses based on **<u>target</u>** performance." The reference to "target performance" applies to overall ICP results. **<u>Any ICP compensation in excess of target is funded fully by shareholders, not ratepayers</u>**. Additionally, the Sempra Utilities have a strong and consistent history of funding ICP above target,[20] which demonstrates the challenging yet achievable nature of the financial target goals at issue and the well-established shareholder contribution to ICP. This demonstrates a built-in alignment and balancing of shareholder and ratepayer interests in the ICP request, contrary to TURN's claims.[21] Perhaps Mr. Sugar is conflating SDG&E and SoCalGas's request with that of other utility GRC requests for the recovery in rates of the **<u>actual</u>**

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[18] See D.96-12-066, 1996 Cal. PUC LEXIS 1111 at *9 ("Any savings the utility can generate between general rate cases belong to the shareholders. In exchange for this opportunity, the shareholders take on the burden of added expenses it may incur during a rate case cycle.").
[19] SDG&E-22 and SCG-21 (Robinson) at DSR-7:19 (emphasis in original).
[20] *Id.* at DSR-7, DSR-8, and Table DSR-4.
[21] TURN (Sugar) at 14.

or **recorded** ICP award payment (i.e., target ICP award + ICP award above target), but that is not the case here.

Otherwise stated, SDG&E and SoCalGas **removed** the part of their forecasted reasonable compensation costs that exceeds target performance from their GRC request before filing, establishing that shareholders would fund the portion of forecasted ICP costs above target.[22] This demonstrates that financial incentive metrics for the ratepayer-funded portion of ICP are conservatively established, such that ratepayers are only asked to fund forecasted ICP that "meets target." In that way, the ICP request truly aligns and balances shareholder and ratepayer interests. Under the SDG&E and SoCalGas model, ratepayers only pay for forecasted ICP at target, while realizing the benefit of established shareholder contributions to employee compensation and the utilities' achievement of optimal financial results in future rate cases.

In addition to providing ratepayer benefits in future rate cases, optimal financial performance on a consistent basis results in SDG&E and SoCalGas maintaining strong credit ratings. These credit ratings enable the utilities to access capital markets (debt markets) at favorable market rates to fund on-going operations and projects, thereby preserving their high standards of service and safety and reliability while also providing the ability to finance new customer-driven investments and initiatives authorized by the Commission. Indeed, it is extremely important to understand that positive investor perceptions, and by proxy our resulting financing ability, have the potential to change overall investment risk and should result in lower long-term debt rates, now and in the future. That is why a financially strong and healthy utility matters to ratepayers, why it is reasonable that a financial metric be a component of the ICP, and why ratepayers should fund the target-equivalent amount of the ICP.

Regarding the important question raised by TURN: Do ratepayers benefit from SDG&E and SoCalGas achieving optimal financial results? Based on the foregoing facts, the answer is a resounding YES.

B. Financial Goals

TURN witness Mr. Sugar argues that the utilities have not provided evidence that exceeding authorized returns benefits ratepayers and that "relatively few Sempra Utilities employees have a significant role… in affecting the ICP measures of financial success."[23] This

[22] *See* SDG&E-22 and SCG-21 (Robinson) at DSR-7, DSR-8, and Table DSR-4.
[23] *Id*. at 7.

misses the point of financial metrics. Although all employees may not have direct influence on **all** aspects of annual earnings, all employees do have direct influence on ensuring that SDG&E and SoCalGas operate safely, reliably and efficiently, which contributes to and is essential to a utility's financial health.

Mr. Sugar's arguments about targets being related to year-over-year financial results and exceeding authorized ROEs miss the point, because financial targets for ICP are not based on these metrics. That said, we are very proud of the fact that over time both SDG&E and SoCalGas have generally reported improved financial results on a year-over-year basis. As noted above, the Commission has acknowledged that this type of performance should be rewarded. Targets to merely achieve (and not exceed) financial results that equate to ROEs at authorized levels do not provide an incentive for employees to seek out and implement efficiencies and other operating process improvements.

Apparently misunderstanding how ICP performance metrics work, much of Mr. Sugar's testimony is focused on how different issues in year-over-year earnings increases can be attributed to one-time items.[24] As noted above, however, ICP targets are not based on prior year earnings. These forward-looking targets already include the impacts of cost efficiency programs and many of the one-time earnings drivers that Mr. Sugar points out. These issues are included up front in the targets themselves. This means that as these events unfold and affect earnings, the impact on the ICP results is minimal, to the extent that the projected impact of these events is part of the ICP targets. Many of the events that Mr. Sugar identifies as earnings drivers on which employees have little to no impact are already included in the earnings target for the ICP and therefore have minimal impact on payouts. Moreover, if any of these events unfold more favorably to the company or if any positive one-time events that were not foreseen in the setting of the ICP plan were to take form, the ultimate impact would be to increase the shareholder funding of the ICP in that year, because ratepayer funding is only at the target level. Any efficiencies or new ways of doing business would be 1) included in the following year's ICP financial target setting, and 2) be included in history and rolled into the next GRC. Thus the ICP financial metrics already reflect efficiencies that management expects to sustain and realize.

In sum, employees at SDG&E and SoCalGas have a direct impact on safety, reliability, customer service and ultimately the level of earnings achieved. Moreover, individual employees

[24] *Id*. at 7-9.

take pride in their work and their ability to positively impact the company. Strong operations, wise investments, operational efficiencies, and carrying out the day-to-day work load are important. Mr. Sugar is misguided in thinking that the average day-to-day employee has no impact on the financial health of our companies.

C. Sempra Compensation Committee Discretion

Mr. Sugar accuses SDG&E and SoCalGas management of "cherry-picking" the financial goals.[25] He claims that ICP financial results exclude "the bulk of the earnings that Sempra Energy and SDG&E were suffering from wildfire litigation."[26] What Mr. Sugar fails to recognize is that SDG&E and Sempra's financial targets, and the resulting ICP financial targets, in any given year did **not** reflect any earnings impacts as a result of wildfire litigation or the early closure of SONGS. So, while the ICP guidelines allow for the exclusion of up to 90% of any losses reflected in actual net earnings in the determination of the ICP financial results, since the ICP financial targets did not anticipate any impact due to these events, the inclusion of 10% of the earnings impact in the determination of the ICP financial results actually reduces the amount of compensation awarded.

Further, Mr. Sugar attempts to use Repairs Tax Adjustments as an example to further demonstrate how ICP is beneficial to only shareholders. Although Mr. Sugar states that he is not attempting to address the substance of the tax issue itself (and SDG&E/SoCalGas witness, Ragan Reeves, can address such issues), I reiterate that this is another example of how between rate cases, items can either positively or negatively impact financial results. Therefore, his discussion of the tax issue is not insightful to, or supportive of, his overall premise. This is not an ICP issue, but even if it did result in ICP earnings being above the target for that year, shareholders paid for the excess, not ratepayers.

Mr. Sugar seems to imply that management arbitrarily shifts things around just to make it easier to hit ICP targets. This is not true. At the beginning of each ICP period, the Compensation Committee defines the type of adjustments that are to be applied to the reported financial results in determining the actual ICP financial results. Identifying these adjustments at the beginning of the ICP period ensures 1) that the ICP financial metrics are more closely associated with strong operating performance and 2) that actual ICP financial results reflect an

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[25] *Id*. at 9.
[26] *Id*.

apples-to-apples comparison with the financial targets, upon which the ICP financial metrics are based. In fact, the Compensation Committee is operating exactly as the Commission intended. As the Commission stated in the final decision for the utilities' 2012 GRC, "SDG&E and SoCalGas are in the best position to decide what metrics to use to measure the performance of its employees, and to revise the metrics as UCAN has suggested would result in the Commission's micromanaging of the Applicants' variable compensation."[27]

III. CONCLUSION

TURN takes issue with a number of financial goals in the ICP and argues that the financial goals in the ICP are not aligned with the interests of ratepayers. In this rebuttal, I have shown that not only do employees have direct and indirect impacts on the actual financial results in any given year, but financial results themselves have an impact on ratepayers. A financially strong utility is good for the ratepayer. A financially strong utility will have the ability to attract more external funding, if needed, at lower rates and allow the utility to be more flexible with its financing, reducing the cost to ratepayers in future Cost of Capital proceedings. It is reasonable for the Commission to recognize that providing employees with an incentive to run the company efficiently while still focusing on safety, reliability and customer service is a smart policy and that the achievement of sustainable efficiencies does get reflected in future GRCs, which benefits ratepayers. The Commission itself provides utilities with incentives to make decisions that improve financial performance, implement legislative mandates, and provide services to low income customers. Providing employees an incentive to ensure a strong and financially healthy company should be no different. And as stated, the total compensation of SDG&E and SoCalGas' employees, which includes ICP, is in line with the competitive market. To deny any portion of ICP would be to deny recovery of prudent and reasonable costs.

This concludes my prepared rebuttal testimony.

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[27] D.13-05-010 at 882.

IV. WITNESS QUALIFICATIONS

My name is Robert M. Schlax. I am Vice President, Accounting and Finance and the former Controller and CFO and Treasurer of SDG&E and SoCalGas. I joined the company in 2005 as Vice President and Controller of SDG&E and SoCalGas. In October 2008, I was appointed CFO. In my expanded position, I oversaw all of the financial planning and budgeting, energy risk management, financial reporting, debt management, utility accounting, and affiliate compliance for SDG&E and SoCalGas, until March 28, 2015.

I have a Bachelor's Degree in Accountancy from the University of Illinois and a Master's Degree in Business Administration from Pepperdine University.

Prior to joining SDG&E and SoCalGas, I served as CFO, Treasurer and Vice President of Finance at Mercury Air Group, Inc. from 2002 to 2005. Before 2002, I held various management positions of increasing responsibilities within the accounting and finance departments at Unocal Corporation.

I have previously testified before this Commission.