Labor Costs and the Rate Case

Incentives, staffing, and benchmarking in a tight economy.

By David W. Sosa, Ph.D., and Virginia Perry-Failor

In several recent utility rate cases, regulators, under pressure to contain rate increases, have disallowed a portion of a utility's claimed employee compensation expenses, citing local economic conditions and the need for austerity. Ratepayers should of course expect that the costs that lie behind the rate remain "just and reasonable." However, if a utility is unable to recover reasonably incurred costs through its rates, its overall costs might rise, jeopardizing its financial health, Future ratepayers might end up paying more for service. Quality of service ultimately might suffer. Moreover, management's ability to keep the ship running might be compromised if companies are denied flexibility to adopt viable alternative compensation packages, or if certain components of employee compensation are inappropriately disallowed.

In the typical rate case, the utility offers evidence that its employee compensation costs are reasonable. If the evidence proves insufficient, regulators may choose to disallow certain requested costs. The regulator must review the evidence and consider how a cost allowance will affect rates. However, if regulators focus on specific components of employee compensation—without adequately considering the reasonableness of total costs—then the rate order might do financial harm to the utility, and, in the long term, to ratepayers.

Utilities can choose different ways to present labor costs to regulators to best support their claims of reasonableness—even as regulators, too, can and should consider a range of factors in reviewing compensation and utility revenue requirements. Here, we look at both sides of the rate-making process, and discuss some key trends in utility compensation practices.

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Trends in Cost Management

A utility's employee compensation typically comprises cash compensation—salary and incentives—and non-cash compensation, including pension and retirement plans, medical and dental care, and other benefits. The Bureau of Labor Statistics (BLS) reported that through September 2011 approximately 61 percent of employee compensation at utilities came in the form of cash wages and salaries, while the remaining 39 percent represented benefit costs.[1] Across all industries, the costs of non-cash compensation have climbed swiftly, prompting utilities and other employers to deploy a range of strategies for managing these expenses. Examples include retirement plan restructuring; increased use of incentive-based compensation; and reductions in headcount.

First, utilities have switched employees from defined-benefit pension plans to defined-contribution pension plans, thereby shifting pension funding responsibility to employees. From 1980 through 2008, the proportion of private wage and salary workers participating in defined benefit pension plans fell from 38 percent to 20 percent.[2] Over the same period, the percentage of workers covered by a defined contribution pension plan—that is, an investment account established and often subsidized by employers but owned and controlled by employees—rose from 8 percent to 31 percent.

Second, utilities have extended incentive compensation to more employees and increased the amount of total compensation at risk by implementing plans that link a portion of an employee's compensation to his or her achievement of individual and companywide goals. A recent Towers Watson survey of utility compensation, which was cited in a decision by the Indiana Public Service Commission, reported that, "93 percent of the individuals in exempt-level positions were eligible for annual incentives."[3,4]

Third, through a variety of mechanisms, including hiring freezes and severance programs, many utilities have reduced employee headcount in recent years. The BLS reports that total employment in utilities fell from around 600,000 in 2001 to 555,000 as of November 2011.[5] However, as with all workforce initiatives, utilities must be

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careful that any changes made don't compromise safety, reliability, and quality of service.

At the same time that utilities seek to rework their employee compensation plans to better control costs, they're also facing a wave of retirements and, as a result, a shortage of qualified workers in many areas. Between 2009 and 2015, approximately 46 percent of skilled technicians and 51 percent of engineers in the utility sector will become eligible for retirement.[6] Some employees have deferred retirement in light of economic conditions; still, the replacement of these skilled workers is a growing problem. Moreover, industry-wide goals to "replace aging infrastructure and achieve modernization objectives"[7] mean that utilities will need to add staff over and above the replacements for those retiring—including, perhaps, different resources at a time when younger qualified workers and trainable employees are in short supply.

In fact, utilities across the country are participating in new initiatives for identifying and training qualified candidates; the Center for Energy Workforce Development's members include more than 80 energy-related enterprises, including utilities, but it takes time to adequately prepare employees for certain industry roles. For example, it can take 10 to 12 years to fully train a lead lineman.[8] Meanwhile, many U.S. universities have scaled back their electrical engineering programs, and many foreign graduate students are finding attractive opportunities in their home countries, causing the pipeline of engineering talent to run low.[9] These labor market conditions limit the talent pool available to utilities and put upward pressure on the levels of compensation needed to attract and retain qualified employees.

Tools for Regulator Review

In determining rate changes, regulators must take into account the full range of economic challenges and the remedies that utilities are employing to combat them. More specifically, regulators should focus on total compensation, plus the trend of expenses in the recent past.

In particular, however, regulators must stay mindful of factors that tend to make a simple apples-to-apples comparison perhaps less indicative than it might otherwise appear, such as: 1) offsetting tradeoffs between cash- and non-cash compensation schemes; 2) the financial value of goals achieved or missed under incentive compensation plans; 3) employee productivity as affected by conservation or efficiency programs; and 4) how industry benchmarking can be affected by the diversity of economic conditions among local utility service territories.

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When regulators evaluate individual components of employee compensation, they must be careful to account for the fact that companies are changing the mix of cash and non-cash compensation. Increases in one component of compensation might offset decreases in another.

For example, a utility might increase employee cash salaries to offset the non-cash effect of shifting employees from a defined-benefit pension plan to a defined-contribution pension plan. The appropriate question for regulators to address is: How will changing the levels of total employee compensation affect rates? Regulators' examination of one particular component without adequate emphasis on total costs might be misleading.

Regulators also must take a similarly holistic approach to evaluating incentive compensation. The objective of these programs should be to encourage individual and collective employee behavior that benefits ratepayers as well as the company. Incentive compensation programs will obviously vary across utilities, based on management objectives and company-specific circumstances. To be most effective, however, and to support the recovery of program costs, these programs should have clearly defined goals and objective measurement criteria. Program goals might include improved reliability, customer service, expense management, and financial performance. For their part, regulators need to be transparent about the extent to which they consider financial criteria—which benefit ratepayers as well as shareholders—acceptable program metrics for compensation expense to be recoverable.

Some utilities have seen increases in employee productivity over the past several years, and that's a significant benefit for ratepayers. As employees work longer and harder, they reduce output-adjusted compensation costs, all else being equal. However, evaluations of productivity can be complicated when utilities are attempting to reduce output—for instance, developing energy efficiency and conservation-related resources, which is increasingly becoming the industry norm. Productivity is traditionally measured according to level of output—electricity sales, for instance—per unit of labor input; more output per unit of labor input would denote an increase in productivity. However, gains in energy efficiency might cause a decline in electricity sales per unit of labor input—and productivity, by this measure, will appear to be declining as well, even though employees are performing effectively. For this reason, standard labor productivity metrics might not capture the full scope of employee

effort and achievement, thereby understating labor productivity.

Benchmarking can help regulators understand employee compensation cost levels and trends, and determine whether requested cost recovery is reasonable. Benchmarking also can assist regulators in evaluating more detailed questions, such as: How does the target utility compare to peers in terms of labor productivity, or in terms of cash compensation?

In particular, peer group benchmarking compares the business performance and practices of a company to those of comparable companies. This technique, which companies, market analysts, and regulators often rely on to evaluate operational and financial performance, can be used to assess indicators of overall company performance as well as the performance of specific activities relative to peers.

However, another benchmark is being introduced in rate cases with greater frequency: the comparison between measures of utility compensation and measures of local economic conditions, including wages and employment. Although regulators might find it useful to look at the local wages of workers who have skills similar to utility employees, general wage and employment rates aren't appropriate benchmarks for evaluating employee compensation costs, for several reasons. As described above, the utility labor force is highly specialized and characterized by a scarcity of qualified personnel. Utilities compete with one another, regionally and even nationally, for employees to fill many positions. In the ratemaking context, evidence regarding total compensation costs—including over time and relative to other comparable companies—is critical. Regulators might also be interested in evidence regarding the utility's salary structure and individual components of compensation. However, it's critical to evaluate these measures relative to the appropriate benchmarks, which must be derived from comparable companies and not merely on the basis of geographic proximity.

Identifying an appropriate benchmark group—or panel of comparable companies—will allow regulators to focus on the regional or national labor market in which a particular utility competes. It also will provide a reliable context for evaluating both the level and format of utility compensation expenses. Companies should be aware that regulators might be tempted to interpret a benchmark as a bright line, so it might be important to discuss the statistical properties of the benchmark sample in any interpretation of results.

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Two principal steps are involved in peer-group benchmarking.

- *Normalization:* The evaluator should determine whether the cost or performance measures at issue can be directly compared across companies, or whether a common means of measurement must be established for presentation to regulators. In the case of employee compensation, these costs will vary based on a number of factors including customers served, geographic region, and degree of vertical integration. Therefore, aggregate measures of employee compensation expense must be normalized—that is, transformed into a common unit of measurement—before a meaningful comparison can be made between the subject company's performance and the performance of companies in the benchmark group. For employee compensation costs, measures of output, including sales and customers, are the commonly used normalization measures. Another normalization factor is number of employees.
- *Panel construction:* Once a common basis of comparison has been established, the evaluator needs to construct the panel of companies—a list of "comparables," in real-estate parlance—against which financial or service-level performance can be compared. The selection criteria will depend on the objective of the exercise. For example, regulators might want to conduct a broad evaluation of a utility's performance relative to the entire electric industry. That would require a benchmark group that includes as large a group of utilities as possible, screening for company characteristics that are relevant to the particular compensation measure at issue. As a general matter, the selection criteria for benchmark companies would be based, in part, on company characteristics that affect expense levels, such as degree of vertical integration and lines of business.

Since any given geographic area will likely have only one regulated electric utility and one regulated gas utility, companies must recruit for skilled workers regionally and nationally. Factoring in the previously mentioned labor challenges utilities face, regulators will need to benchmark salary ranges by job description; this lens should reflect the regional and national labor markets in which utilities compete for talent. The commonly used sources for such data include industry-specific and broad-based compensation surveys. To the extent that utilities have outsourced positions that require lower skill levels and draw from local markets—for example, non-critical security services—they wouldn't factor into employee compensation costs.

Some U.S. regulatory commissions have explicitly acknowledged that utilities' employee compensation strategies »

are developed to attract, retain, and motivate employees, and that the proper concern of regulators is whether a utility can demonstrate that the overall level of employee compensation expenses is reasonable. These regulators have established criteria, including market labor rates, for evaluating reasonable compensation levels, but they recognize that the allocation of the package over its various components, including incentive compensation, is a matter best left to management. The Massachusetts Department of Public Utilities (MDPU) offers an example of this approach.

The MDPU sets forth evaluation criteria that explicitly recognize "that the different components of compensation are to some extent substitutes for each other and that different combinations of these components may be used to attract and retain employees." Utilities are required to demonstrate that their costs conform to those criteria and that their total unit-labor cost "is minimized in a manner supported by their overall business strategies." Utilities are also required to compare their costs against a market-based standard.[10]

Regulators in Indiana and Nevada also have considered overall compensation against established evaluation criteria. In Indiana, regulators evaluated Vectren South's compensation package, including incentive compensation up to a board-approved level, and found that it was at the low end of the competitive range in the market, relative to comparable companies. As a result, Indiana regulators approved the utility's compensation request.[11] Similarly, in Nevada, the Nevada Public Utilities Commission (NPUC) has evaluated a combined compensation package of payroll and benefit costs. The commission found that Sierra Pacific had actually reduced its payroll and benefit costs by about $16 million, "reflecting the reduction in growth that has occurred during the recession,"[12] and approved Sierra Pacific's compensation request.

What Utilities Should Do

Given the complex compensation issues involved, and the competing claims of stakeholders in rate proceedings, utilities need to anticipate the issues that intervenors and regulators are likely to focus on and develop a record that establishes the reasonableness of employee compensation expenses. Utilities' compensation presentations should offer regulators clear and concise information regarding levels of total employee compensation over time and compared with other utilities. As much as possible, these presentations should conform to prior commission decisions and should reflect concerns about current economic conditions. To the extent changing circumstances justify departures from prior regulatory precedent, these departures should be identified, and the justification for the change should be clearly articulated. Among other things, the utility should be able to identify changes in employee compensation and explain to regulators why these changes have occurred and why the observed expenses are reasonable.

Also, to the extent that a utility has been able to reduce employee compensation costs through discrete initiatives, such as severance programs or initiatives that improve labor productivity, regulators might be tempted to appropriate some or all of the expense savings prior to the rate effective period, on behalf of ratepayers. However, this treatment is short-sighted because regulatory lag—the time between when a utility initiative begins generating expense savings and when that savings is passed on to consumers via rates—creates incentives for utilities to implement cost-savings initiatives with uncertain outcomes. If an initiative is successful, the utility will have the opportunity to capture some of the expense savings before they're passed on to ratepayers, compensating the company for some of the assumed risk.

Utilities should remind regulators that regulatory lag benefits ratepayers and encourage commissions to take a forward view rather than attempting to capture expense savings retroactively. Additionally, employee compensation levels might reflect rising productivity—for example, staff reductions might have contributed to increased productivity, which benefits ratepayers. Individual compensation might have risen to reflect improved performance, even though aggregate compensation has fallen. Utilities can assist their commissions to place individual compensation levels in context by offering statistics that describe productivity through time. F

Endnotes:

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