DELMARVA POWER & LIGHT COMPANY
REBUTTAL TESTIMONY OF ERNEST L. JENKINS, SR.
BEFORE THE DELAWARE PUBLIC SERVICE COMMISSION
CONCERNING AN INCREASE IN GAS BASE RATES
DOCKET NO. 10-237

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1. Q: Please state your name and position and business address.

A: My name is Ernest L. Jenkins, Sr. I am Vice President, People Strategy and Human Resources (PS&HR) for Pepco Holdings, Inc. (PHI). In that role, I serve as the senior executive for human resources for PHI's operating companies, including Delmarva Power & Light Company (Delmarva or the Company). My office is located at 701 9th Street NW, Washington, DC 20068.

2. Q: Please state your educational and professional background.

A: My educational and professional backgrounds were included in my Direct Testimony.

3. Q: Have you previously filed testimony in this proceeding?

A: Yes, I have filed testimony previously in this proceeding.

4. Q: What is the purpose of your rebuttal testimony in this proceeding?

A: The purpose of my testimony is to address certain proposals made by witnesses of Commission Staff (Staff) and the Division of the Public Advocate (DPA) regarding non-executive and executive compensation. Specifically, I will address Staff position regarding the following:

- non-executive compensation expense,
- executive compensation expense,
- supplemental executive retirement plan expense (SERP), and

- employee benefits.

I will also address the DPA's position regarding supplemental non-executive compensation issues, supplemental executive retirement program and employee benefits costs discussed by DPA Witness Crane in her direct testimony.

The positions advocated by Staff and DPA are not reasonable, and are incompatible with the need to allow management to make decisions concerning the management of employees and the operation of the Company. My testimony will focus on the strategic aspects of how these programs impact Delmarva's ability to manage its business in an effective manner to the benefit of our customers. Company Witness VonSteuben addresses the specific ratemaking treatment for these programs.

As a recognition of the current difficult economic times, it also should be noted that for the purposes of this proceeding Company Witness VonSteuben removed executive incentive compensation from test period earnings.

5. Q: <u>Please describe the positions of Staff Witness Smith and DPA Witness Crane.</u>

A: Staff Witness Smith and DPA Witness Crane make the following adjustments that my testimony will address:

- Incentive Compensation - removes all non-executive incentive compensation;
- Executive Compensation Expense - removes several of the executives' benefit costs associated with the top five officers;

- removes the inclusion of Supplemental Executive Retirement Plan (SERP) expenses because, in his opinion, customers should not fund additional retirement benefits for PHI Officers, and;
- removes the Company's adjustment to reflect an increase in employee benefits for medical, dental and vision expenses.

I do not agree with these adjustments and I will address each below.

6. Q: **<u>You stated above that both Staff and DPA recommend removing non-executive incentive compensation from cost of service. Did Staff Witness Smith and DPA Witness Crane include any incentive compensation associated with safety and reliability goals?</u>**

A: No, they did not. Both Staff Witness Smith and DPA Witness Crane recommend that all non-executive incentive compensation be removed

7. Q: **<u>Do you agree with Staff Witness Smith and DPA Witness Crane?</u>**

A: No, I do not. As I will explain, Delmarva's compensation levels are carefully set to benefit both Delmarva's customers and its employees. The recovery of the incentive programs should be allowed.

8. Q: **<u>Please describe the Company's strategy in designing compensation and benefits programs.</u>**

A: Compensation and benefits are the key components that enable all businesses, including Delmarva Power, to attract and retain skilled employees at all levels of the organization. Delmarva Power actively competes for skilled employees in the marketplace, and to the extent that Delmarva's overall compensation program lags the market, it negatively impacts Delmarva's ability to both recruit and retain skilled employees, to the detriment of our customers.

9. Q: <u>How does the Company determine whether its non-executive compensation and benefits programs are competitive</u>?

A: The Company retains the services of external compensation and benefits experts to assist in performing an external benchmarking evaluation of all non-union positions every two years. We use the services of these firms because of their expertise in the industry.

10. Q: <u>Please describe this non-executive compensation and benefit program.</u>

A: Management assists the compensation experts in understanding the roles and responsibilities of each of the positions and the key markets that should be considered in benchmarking each job, based on the Company's recruiting efforts. For example, some positions are unique to utility operations, and others are positions that are also common to other non-utility firms. For positions that are not unique to utilities, the expert also considers market data provided by general industry companies in addition to utility data. Competitive compensation data are analyzed using the median (50^{th} percentile) statistics.

The Company designs its compensation plan to be in the middle of the competitive labor market. In other words, our compensation package is intended to be neither at the high end nor the low end of the markets in which we compete for labor resources. Based on the job evaluations, position information, and market definitions for each position, the expert develops competitive market data for each position. These market data include both salary and incentive compensation for each position. The compensation expert also assists the Company in making recommendations on updating its management salary structure (commonly known as salary ranges or levels) based on the market data. Each position is assigned a salary grade and range from minimum to maximum, and also an incentive compensation target which equates to the total compensation structure.

11. Q: <u>How does the Company use the salary ranges developed through benchmarking?</u>

A: The salary ranges are used by the Company when making decisions regarding the pay for new and existing employees. Actual salaries are determined based on the experience and performance of the employees, as well as the supply and demand for employees with particular skills and abilities in the market.

12. Q: <u>Please describe the results of the most recent non-executive market evaluation that was completed in 2009.</u>

A: Overall, the study found that PHI's compensation program is competitive and consistent with utility and general industry practices. However, exceptions were noted. For example, for non-executive positions, our incentive targets are below market levels for higher graded positions, and our current compensation program has limited ways to recognize and reward individuals for the quality of their performance. In other words, with respect to incentives, PHI's and Delmarva's compensation programs are below those of the average company in the industry.

13. Q: <u>Does the Company follow a similar competitive market evaluation process for executive positions?</u>

A: Yes. The Compensation/Human Resources Committee of the PHI Board of Directors retains an independent expert, Pearl Meyer and Partners, to assist it in the design of PHI's executive compensation programs. The benchmarking process for executive positions is essentially the same as for non-executive compensation; however, the market typically provides executive positions with additional executive compensation elements not typically provided to non-executives, to be competitive in the labor market for executive talent.

14. Q: <u>What are the additional executive compensation elements you reference?</u>

A: One element is long term incentives in the form of Company stock. Such stock incentives are a common element of compensation for executives in investor owned companies. Indeed, they are expected. Staff Witness Smith proposes removal of elements of this plan from the revenue requirement despite the fact that this plan promotes the long-term business interest of the Company and its customers by ensuring that the Company retains top executives.

Another element included in the Company's executive compensation plan are programs that allow executives to not be penalized by benefits limits established by the IRS, such as limits on qualified pensions and contributions to qualified salary deferral plans commonly referred to as 401k plans. The SERP and deferred compensation match benefits, which are standard offerings of investor owned companies are excluded by Staff Witness Smith and DPA Witness Crane.

In addition, Staff Witness Smith opposes including in cost of service the costs associated with certain perquisites that are offered by the Company to a few of its executives. Examples of such perquisites are transportation allowances and costs associated with financial planning, tax preparation and executive physicals. It is standard practice for companies to provide executives as part of their overall compensation package perquisites such as these in an effort to attract and retain the best executive talent. Hiring and retaining these top executives to oversee the operations of the Company ultimately benefits all of our customers.

All of the elements of executive compensation described above benefit the Company's customers by ensuring that the Company is able to attract and retain talented executives.

15. Q: <u>What conclusions did the Committee's expert make regarding total cash compensation for PHI executives?</u>

A: As described in the Compensation Discussion and Analysis section of the Proxy Statement and 2009 Report to Shareholders, Pearl Meyer and Partners commented that total cash compensation (salary plus annual bonus) for executive officers was within the market median range of practices, and recommended no changes for 2010.

16. Q: <u>What conclusions did the Committee's expert make regarding total direct compensation for PHI executives?</u>

A: As described in the Compensation Discussion and Analysis (CD&A) section of the Proxy Statement and 2009 Report to Shareholders, Pearl Meyer and Partners commented that total direct compensation (salary + annual bonus + long term incentive) for executive officers was somewhat below the midpoint of the competitive range market median range of practices. The expert concluded, however, that the total compensation and benefits for the executive officers including retirement plans and other benefits were reasonable, and did not recommend an increase in long term incentive targets for 2010. The expert advised the Committee to review the long term incentive payout targets for the top executives in 2010 particularly related to the 2010 Utility Peer Group.

17. Q: <u>What conclusions did the Committee's expert make regarding perquisites for PHI executives?</u>

A: As described in the Compensation Discussion and Analysis section of the Proxy Statement and 2009 Report to Shareholders, Pearl Meyer and Partners advised the Committee that perquisites were modest in comparison to the market. It is my opinion that even though the perquisites were described as modest by the Committee's expert, this element of compensation is essential to the Company's ability to attract and retain executive talent.

18. Q: <u>Please comment on Staff's and DPA's recommendations to remove the SERP expenses.</u>

A: In 2008, the Company's actuary Watson Wyatt (now Towers Watson) completed a study for the Company regarding the design of the Company's retirement plans for executives which include both qualified and SERP elements. That study compared the qualified pension and SERP plans of the Company to plan designs of firms in the Company's peer group described in the PHI 2008

Proxy Statement. The study found that the benefits provided under the Company's qualified and SERP plans at normal retirement age of 65 were below the median of those provided by the firms in the peer group. As the Company's current plan designs are below those of our peer group, the Company is already at a disadvantage as it relates to the long term retention of executive talent. The SERP related expenses are required in order to attract and maintain skilled people needed to operate the organization. Consequently these represent valid costs of doing business and should continue to be reflected in rates. The decision by the Company to offer its SERP plan is a reasonable one. Therefore, in my professional judgment, the Staff's and DPA's recommendations to remove the SERP related expenses are inappropriate and unsupported by the market data.

19. Q: <u>Please describe the Company's proposed adjustment for employee benefits.</u>

A: As described by Company Witness VonSteuben, the Company included an adjustment to test period operation and maintenance expense that would reflect an increase in medical expense by 8%, and dental and vision expense by 5% based on the work on the Company's benefit expert, Lake Consulting, Inc. Staff Witness Smith and DPA Witness Crane rejected this adjustment.

20. Q: <u>Do you agree with Staff Witness Smith and DPA Witness Crane?</u>

A: No, I do not. Company Witness VonSteuben addresses the regulatory ratemaking principles on why this adjustment is necessary and I will provide the support for the increase. The Company submitted information from the Company's benefit expert, Lake Consulting Inc, supporting the Company's requested increase. The Company did not arbitrarily select the proposed increase. Rather, it relied upon an expert, Gary Lake, who has vast experience in this subject matter. All of the expert information was provided to Staff in Data Request PSC-LA-145(a).

This information, which was provided to all of the parties, highlights that the Company's estimated benefit increases are on the low end of the range for the Mid-Atlantic region. As an example, the Company used a dental expense rate of 5% while the sample had a range of 5% to 8%, with a mean increase rate of 6.6%. Depending on whether one used Point of Service (POS), Health Maintenance Organization (HMO) or Preferred Provider Organization (PPO) plans for reviewing the medical expense increase in the expert's study, the mean average increases ranged from 11.0% to 11.8%. The Company's 8% estimated increase certainly is reasonable using the provided benchmarks. The Company is using a 5% increase for dental, a 5% increase for vision, and a 8% increase for medical in its financial plan.

21. Q: <u>Pleas e address Staff Witness Smith's position that benefit plan modifications were not reflected in the Lake Consulting Group Study.</u>

A: As previously mentioned, the Company's estimated benefit costs are on the low end of the range for the Mid-Atlantic region as established by the Lake Consulting Group Study. This study focuses on the trend of benefit cost claims. To again cite the dental expense increase trend range, the Lake Study sample had a range of 5% - 8% with a mean increase rate of 6.6%. The Company used 5% for its proforma adjustment as opposed to a higher percentage in the range to provide a conservative allowance for the impact of benefit plan modifications. The Company used this factor when it budgets for this plan.

22. Q: <u>Please address DPA Witness Crane's position that the Lake Consulting Group Study does not address Delaware medical premium customer trends.</u>

A: The Lake Study measures the regional benefit claim customer trends experienced by major health care providers and thus provide a broad perspective.

In terms of Delaware medical premium trends, there are very few healthcare-related insurance companies that have headquarters in Delaware. Regardless, the Lake Study includes Aetna which is a carrier that has a reasonable amount of the Delaware healthcare market. In addition, Gary Lake, of Lake Consulting Group, serves as a consulting actuary to Blue Cross/Blue Shield – Delaware and thus has expert insight into both the Delaware and regional health care markets.

In addition, there are several factors which support the use of regional healthcare trend information for the Company. It is Mr. Lake's opinion that Delaware is consistent in the Mid-Atlantic region in terms of benefit cost trends. Thus, the use of regional healthcare trend information makes more statistical sense both in terms of the overall cost trends in the industry as well as the Company's employee base.

23. Q: <u>Do you agree with Staff Witness Smith that several executive benefits should be excluded from rates?</u>

A: No, I do not. These benefit plans are an important element of the Company's overall executive compensation package, and are required in order to attract and retain executive talent. As previously described, the Compensation/Human Resources Committee of the Board of Directors engages an independent expert to confirm that its executive compensation is adequate to attract the talent necessary to maintain an organization that is able to maintain financial stability, attract necessary investment, and provide safe and reliable service to our customers.

Staff Witness Smith's suggestion that several of the existing benefits should be excluded from rates (a denial of recovery of costs) constitutes a penalty upon Delmarva and PHI, despite the fact that its compensation package is actually somewhat below that of its market comparators. The careful analysis that the Committee's independent expert performs to establish its executive compensation proves the opposite, however. We are very careful to be sure that PHI's executive compensation package strikes the right balance to attract the necessary talent while remaining reasonable and fair to customers and our shareholders. I think it is clear that we have done just that.

24: Q: <u>Do you agree with Staff Witness Smith's and DPA Witness Crane's recommendation that non-executive incentive compensation should be excluded from rates?</u>

A: No, I do not. First, it would be helpful to understand the drivers of our incentive compensation. The Company's performance incentive plans are part of employees' total compensation package. Delmarva could simply increase base salaries and provide no incentives. Instead, our leadership has decided at this time to pay a lower base salary while providing opportunity for our employees to earn that higher reward based upon performance. Having a portion of employees' compensation based upon performance (or "at-risk") is an accepted and widely used mechanism to motivate employees to be more efficient and productive.

For Delmarva, this program helps to focus employees' attention and efforts on achieving the Company's goals. Many of these goals are explicitly customer-oriented. To the extent that other goals are financial in nature, such goals help motivate employees to keep costs down and thus, benefit customers in the ratemaking process. For example, Delmarva has not had a gas distribution rate increase since 2007. While there are many factors behind that fact, there is no doubt that one of those factors has been the significant attention that our employees pay to efficiency and cost control.

While the specifics of the annual incentive program differ among levels, they all have the same framework of drivers. In particular, all of the programs have employee measures such as safety. All of the programs also have customer satisfaction components including for example, such factors as measurements from the Market Strategies, Inc. (MSI) survey and field surveys of customers who have had recent interactions with the Company. Reliability measures are also included. Finally, the programs all have financial components such as O&M expense control, managing capital expenditures and achieving our net income targets overall, which, if achieved, lower the revenue requirements to customers. All three of these areas work in concert – satisfied employees looking out for the safety of themselves and the public and serving the needs and expectations of satisfied customers, and doing so in a financially responsible way. To argue that incentives driven by these critical performance measures are inappropriate to the degree that rate recovery of them should be denied is unreasonable.

25. Q: <u>Please comment on Staff Witness Smith's and DPA Witness Crane's recommendations to remove non-executive incentive compensation.</u>

A: The financial portion of the Company's incentive plans directly benefits our customers in many ways. First, having a financially strong and healthy utility does directly benefit customers. The financial targets are set to allow for reasonable levels of investment to meet our customer reliability, safety and service level obligations and commitments at reasonable costs. In addition, a goal of the incentive plan is to ensure our employees are careful in spending money and taking care of the Company's assets. If we are successful in this, we will meet or exceed our financial targets, while still providing higher levels of customer satisfaction with safe and motivated employees. By incenting our employees to meet the financial targets, we assure that we are spending money wisely and efficiently, therefore reducing costs to customers.

The Company's total compensation packages are designed to be competitive with other utilities. Whether all of the compensation is in base salary, incentives, benefits or some combination, the Company's pay philosophy is to set overall compensation at the median or 50th percentile of the competitive market.

We have conducted benchmarking and other studies discussed above for years. At this time, management has made what, in my professional judgment, is a correct decision that both the Company and its customers are better off paying a dollar for a goal that is met through an incentive program, rather than paying a dollar and hoping that it is met through a higher base salary program. This is directly supportive of achieving just and reasonable utility rates. The performance of our employees in these "financial" areas has been a major reason why our customers have not experienced a gas distribution rate increase since 2007. By being successful, we can lengthen the period of time between rate cases and we can mitigate the size of increases when rate cases are filed.

As a Company, we are very careful to design an overall compensation program that is reasonable, attracts and retains skilled employees, and provides incentives to our employees to perform at a level that benefits both our customers and our shareholders. As previously explained, we retain the services of an external expert to complete a benchmarking evaluation of all non-union positions every two years to test the reasonableness of our total non-executive compensation program. The benchmarking has proven our overall compensation program to be in-line and, if anything, somewhat below that of other representative companies. I strongly disagree with the recommendations of Staff Witness Smith, and find them to be arbitrary and unsupported by the experts study. I see no legitimate justification for disallowing any portion of the incentive compensation program for our employees.

26. Q: <u>Please summarize how executive and non-executive incentive compensation plans benefit the customer.</u>

A: Our compensation and benefit plans are reasonable and are designed to attract and retain the talent needed to serve our customers at a fair cost. As I have previously stated, there are many ways that these plans benefit the customer, including:

1. They align and motivate employees – These plans send a clear message to employees as to what the Company believes is important to accomplish as team members working together. I also feel these plans positively impact safety which leads to greater efficiency, productivity, higher reliability and customer satisfaction. The cost focus of the incentive program is also designed to reduce the cost of service.

2. They save money both directly and indirectly – Savings in terms of increased productivity, reliability, and safety are directly passed on to the customers in future ratemaking proceedings.

3. They reinforce a team focused participative culture – The Company has established values regarding teamwork and valuing the contributions of all employees. Incentives help to reinforce these behaviors which benefit customers.

4. Finally, incentives as a key component of total compensation allow the Company to compete in the marketplace to hire and retain the best talent. I feel that having the best talent working for our business provides ongoing value to our customers, value that continues to grow over time.

27. Q: <u>Does this conclude your Rebuttal Testimony?</u>

A: Yes, it does.