ITEM NO. CA2

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: September 12, 2017

REGULAR ____ **CONSENT** X **EFFECTIVE DATE** N/A

DATE: August 28, 2017

TO: Public Utility Commission

FROM: Matt Muldoon mjm

THROUGH: Jason Eisdorfer and Marc Hellman

SUBJECT: PORTLAND GENERAL ELECTRIC: (Docket No. UF 4226(1)) Requests reauthorization for up to 3,327,146 shares of common stock for the Company's incentive plan.

STAFF RECOMMENDATION:

Staff recommends the Commission approve Portland General Electric Company's (PGE or Company) application to issue and sell or transfer up to 3,327,146 shares of common stock for the Company's incentive plan (hereinafter the "Application"), subject to the conditions and reporting requirements herein.

DISCUSSION:

Issue

Whether the Commission should re-authorize PGE's remaining outstanding common shares in its Stock Incentive Plan, subject to certain conditions recommended by Staff, including:

- Authority Termination date of March 31, 2024;
- Commitment by PGE to review its current plan and begin work on a replacement plan no later than March 31, 2022, that would conform to prevailing best practices, including elimination of stock options and cash payouts, and default placement of awarded stock meeting vesting requirements directly into recipients' trading or retirement accounts.

Applicable Law

Under ORS 757.405, a utility must obtain Commission approval prior to issuing stocks and bonds, notes and other evidences of indebtedness. The Commission may authorize an issuance if it is for one of the permissible purposes listed in ORS 757.415(1), satisfies the criteria of ORS 757.415(2)(b), and its purpose is not reasonably chargeable to operating expenses or income.(ORS 757.415(2)(c)). Permissible purposes for an issuance under ORS 757.415(1) include the acquisition of property, the construction, completion, extension or improvement of its facilities, the improvement or maintenance of its service, the discharge or lawful refunding of its obligations and the compliance with terms and conditions of options granted to its employees to purchase its stock.

ORS 757.410 provides that any issuance of stocks and bonds, notes or other evidence of indebtedness, and any security shall be void when issued without authorization by the Commission or if issued inconsistently with the Commission's authorization.

OAR 860-027-0030 requires utilities to provide certain information when seeking authority to make an issuance under ORS 757.405-415.

ANALYSIS:

PGE's Application:
PGE seeks authority to issue up to 4,687,500 shares of common stock under its 2006 Stock Incentive Plan (Plan). The Commission authorized the issuance of 4,687,500 shares of common stock for PGE's Plan in 2006, but the authorization lasted only ten years and expired in March 2016. PGE has 3,327,146 shares remaining in its Plan, including 469,673 shares that have been assigned but have not yet met vesting requirements.[1] The other shares authorized by Order No. 06-356 have been depleted.

The Company's board has extended its Plan through PGE's Board Compensation Committee in May 2016 and the plan will be submitted to PGE's stockholders in 2018. PGE does not seek to infuse new shares into its Plan. Instead they ask the Commission to reauthorize remaining outstanding shares, with any assigned or granted shares that do not meet vesting requirements, returned to the pool of available common shares under the Plan.

Conceptual Backbone of Plan
PGE's states that the Company's overall compensation policy is designed to attract and retain highly-qualified employees and to provide them with incentives that align employees with the interests of key stakeholders.[2] PGE states that the long-term incentive program is designed with this philosophy as a guiding principle and that the following considerations serve this principle:

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1 PGE Finance Application 2.
2 PGE Response to Staff IR No. 5.

Performance-Based Pay:
A significant portion of employee pay should be at risk and based on performance relative to key stakeholder objectives. Increasing degrees of responsibility should be accompanied by increasing shares of the risks and rewards of Company performance. Targets of incentive awards should encourage progress in key areas, but should not promote rapid improvements at the expense of safety and reliability.

Competitive Pay:
Employee pay should be competitive within the utility industry and organizations that compete for similar talent. The company considers market data to ensure competitiveness, but does not make automatic adjustments based on benchmarking data.

Team-Based Pay:
Internal pay equity should be maintained to promote respect and teamwork. The Company provides all long-term incentive awards as either performance-based grants or time-based grants. More than 95 percent of awards are provided as performance-based grants.

Performance- and time-based awards with multi-year vesting periods provide a benefit to all PGE stakeholders, in the Company's view, by ensuring goal continuity among management and key employees, and ensuring that strategic decisions and tactical execution are made with stakeholders' long-run needs in mind.

The Company states that the Plan allows the Company the flexibility to provide option-based awards since hiring the best employees requires the company to be responsive to changes that are taking shape in the marketplace. If the industry moves to a philosophy of providing more option-based awards, PGE's management would consider if such a move is appropriate for the needs of its stakeholders. Cash substitution features, in the Company's opinion, could serve a similar purpose, although cash or cash equivalents are not the Company's practice.

The Company indicates that each year it benchmarks its program design to ensure it remains committed to PGE's guiding principles of competitive, performance-and team-based pay. The Company's analysis focuses on a comparison of its long-term incentive program to peer utilities who are PGE's primary competition for talent.[3]

3 PGE Responses to Staff IR Nos. 5-7, including the part of the table above from IR 5, Attachment A, address current use of stock options in plans to attract and retain key personnel at peer utilities.

Staff Conclusion Regarding Need for Authorization
PGE seeks authorization of the issuance, but also, asks the Commission to first consider whether authorization is necessary. PGE believes the authorization granted in Order No. 06-356 is sufficient for purposes of issuing common shares under the Plan. Staff disagrees. When PGE sought authority to issue common stock for its Stock Incentive Plan in 2006, PGE stated in its application no award would be made ten years after the effective date of the Plan, which was March 31, 2006.[4]

Under ORS 757.410, any issuance that is not in conformance with the authorization is void. The authorization granted in 2006 was for ten years. Accordingly, PGE does not currently have authority to issue common stock under the Plan and requires another grant of authority from the Commission to do so.

Staff Concerns with the Plan
PGE states that the Company has never offered employee stock options as a performance incentive under the Plan. However, PGE's extended Plan would continue to allow the Company the flexibility to do so.

PGE is not now issuing stock options and states it has never offered employee stock options as a performance incentive under the Plan.[5] In fact, PGE has stated that the Plan has the flexibility to issues options in case the Plan is unable to issue shares. However, retaining stock options as part of the Company's current Stock Incentive Program, in case utility executive labor markets should again start to compete heavily on the basis of stock options, concerns Staff.

Two Points of Plan Failure – Options[6] and Cash
While options might appear to offer an opportunity for a utility to pay a variable rather than a fixed cost reward, stock options no longer conform to best practices. The Company's benchmarking showed no peer is offering stock options. Popular examples, like backdating at Apple, demonstrate how options were readily manipulated, consistently undervalued, and failed to create target alignments. Where options create asymmetric payoffs and incentives for risk-taking, utility stock holding (not cash receipts or easily manipulated options) build and strengthen desired behaviors.

For example, managers have some control over main determinants of option value, the firm's dividend rate, and volatility of equity. First, directors can influence the firm's dividend rate. Dividend payments impact the stock price, and the exercise prices of

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4 UG 4226 Application of Portland General Electric 2.

5 PGE Response to Staff IR No. 4.

6 *See* 2006 Stock Incentive Plan, Page 2-3, Part 8 "Stock Options", and sub-part (c) thereunder "Payment of Exercise Price", namely "... the option exercise price may be paid in cash ..."

executive stock options are rarely adjusted for dividends. Jolls (1998) shows that managers who receive option grants have a greater tendency to replace dividends with share repurchases. Yet it is a stable and growing utility dividend that is essential to attract and retain sophisticated institutional money managers, such as hold the majority of the Company's stock as shown in the table below. Thus one can see options as disruptive to the long-run success of a utility.

Ownership of PGE by Type[7]

%	POR Owner Type
87.11	Investment Funds
5.74	Hedge Funds
2.35	Pension Funds
1.56	Insurance Co.
1.24	Bank
1.04	Sovereign Wealth Funds
0.49	Individuals
0.26	Governments
0.10	Brokerages
0.11	Misc.
100.00	

Managers may be able to affect the volatility of corporate equity through timing of earnings and other activities. Risk-averse managers who are compensated in salary, bonuses, and stock have incentive to keep the volatility of the firm low when they hold a large fraction of their human capital and their financial wealth in the firm. Such managers are motivated to control risk-increasing in the form of potentially unneeded or not soon useful projects if the increase in total firm risk is larger than the increase in firm value.

A second misaligning factor is found in the instant liquidation features of the Plan. Because alignment is based on long-run common stock ownership, mechanisms that translate retention rewards to immediate cash payments undermine the effectiveness of and underlying theory behind the Plan. Staff notes that all of PGE's officers and directors are subject to stock ownership requirements consistent with Institutional Shareholder Services, Inc. (ISS) top rating. However, there is still opportunity for plan improvement.

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7 Staff accessed the Bloomberg POR US OWN function on July 27, 2017.

Staff Recommends Nudge toward Desired Behaviors
Thaler and Sustein Nudge theory argues for building programs wherein desired behaviors are default outcomes, while less desired behaviors take extra effort on the part of participants. For example, to increase participation in retirement plans, a company might structure a program with auto-enrollment on hire and promotion, with a choice of opt-out that takes effort on an employee's part. Here it is important to note that the main purpose of the Plan is to attract and retain key talent. It is not primarily an executive retirement program.

The Plan's components and aggregate mechanism should be structured so as to create long-term stock ownership by default. The Plan should not internally or conveniently liquidate the Company's stock, but rather should work instead to place awarded and vested shares directly into the accounts of recipients. The result is automatic placement for the long-run into the recipient's long-term holdings. The recipient can sell the shares where necessity demands, but then must deal with trades, complexities, and tax implications individually. That inconvenience creates resistance to sale consistent with Plan goals.

Traditional Transaction Costs and Complexity Minimized
In 2006, various academic assumptions such as by Professor Burton Malkiel of Princeton regarding market transaction costs, difficulty of forming a diversified core portfolio that closely tracked a market index, and so on, were likely accurate. Going forward, funds and exchange traded funds that closely track indexes by essentially owning a material portion of all the component shares of the index now preclude the Company from needing to provide a cash-equivalent choice within the Plan, because of the following factors:

A. The officers, directors, and key employees are financially knowledgeable,
B. Investing in a core balanced portfolio fund or exchange traded index fund at a low annual fee is currently trivial[8], and
C. Tradeable brokerage accounts within retirement vehicles need carry no trade-execution costs as presumed in Malkiel's work.

Automatic liquidation of shares is no longer a constructive feature. The need to decide to sell awarded stock under the Plan could create a small but meaningful barrier to

[8] Consider for example:
1. BlackRock iShares Core S&P 500 ETF seeking to track the investment results of an index comprised of U.S. equities, with an annual expense ratio of 0.04 percent, (IVV);
2. Vanguard 500 Index Fund Admiral Shares with a like target index and an expense ratio of 0.04 percent, (VFIAX); and
3. Vanguard Total Stock Market Index Fund Admiral Shares with approximately 3,600 stocks tracking the U.S total stock market, with an expense ratio of 0.04 percent, (VTSAX).

sale. No-action or inactivity by a Plan recipient would then by designed-default achieve long-run stock-holding and desired alignments.

Company	Options
Allete	0%
Alliant Energy	0%
Avista	0%
Black Hills	0%
El Paso Electric	0%
Great Plains Energy	0%
IDACORP	0%
Northwestern	0%
Northwest Nat Gas	0%
OGE Energy	0%
Pinnacle West	0%
PNM Resources	0%
SCANA	0%
Westar Energy	0%

The chart above shows PGE's peer group is not relying on stock options. That PGE and its peers do not actually rely on stock options is indicative of a need for a comprehensive review by the Company of its Plan. For other energy utilities such as Northwest Natural, such a review and restatement took over a year to complete. Staff therefore recommends that the Commission condition approval now with timely review and restructuring of the Plan before its next expiration date.

Need to Update Plan Assumptions

Staff recommends that the Commission extend the Plan as described herein but adopt Staff's conditions that will cause the Company to start to review and compile a replacement plan two years before the expiration of the current refreshed Plan. As part of that effort, the expectation is not to advance an outdated framework again, but rather have the Company reexamine its assumptions and assertions that will lead to a fully restated replacement plan. Assumptions and reasons without empirical support would need to be replaced or discarded. Options and cash equivalents to stock value would likely not be part of the replacement plan absent substantial theory, benchmarking and logic support for such.

As part of this process, the Company would need to ask non-trivial difficult questions like, "Are our stock payouts well calibrated to be sufficient but not excessive to attract and keep key people? Do we have structured theory and metrics behind our plan components or have we been doing some things because we have always done so, or because distant past market conditions now passed once had such features? Are prevailing understandings like Staff shared herein, memorialized in textbooks[9] and popularized in business media[10] reflective of the actual mechanics of attracting and retaining key talent? Under what conditions will a bonus plan be more likely to attract and retain executive talent and why? And how does PGE best balance Plan elements to enhance management team effectiveness?"

Staff recommends that the Commission not prescribe the replacement plan fully but rather provide certainty that a full and reasoned review and reformulation of the Plan is expected to come before the Commission for timely review.

Other Considerations--Minimal Impact on Capital Structure
In general, expensing of shares directly offsets the value of new shares issued creating minimal if any new impact from shares issued within the incentive plan. In practice, the incentive shares have a tendency to move the Company's capital structure toward 50 percent equity 50 percent debt from a higher debt weighting between common stock flotations.

Expenses
There is no compensation to any underwriter, bank, or agent for services in connection with the issuance of the common stock addressed by this application, except that PGE pays a small fee to Merrill Lynch to administrate the transactions. However, the Company bears the burden in general rate cases to show upon request that the fees for the Company's registrar, for the transfer agent and for general auditing, record keeping, and other costs under the Plan are reasonable and controlled.

No Cash Proceeds
The issuance of stock under the plan brings no cash proceeds to the Company. Rather, the plan is part of the Company's overall compensation package, which is intended to provide incentives to attract, retain and motivate officers, directors and key employees

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9 *See* Chapter 12 – "Agency Problems, Compensation and Performance Measurement" in the tenth edition of "Principles of Corporate Finance" by Brealey, Myers and Allen.

10 *See*, "A Better Way to Reward CEO's" by Phillip Delves Broughton in the Wall Street Journal of July 31, 2017.

of the Company. Consistent with standard OPUC ratemaking practices, half the projected cost of this program is currently recoverable from PGE customers.

Audit Verification of Outstanding Shares
External audits of the Company's financial statements are performed by Deloitte and Touche LLP. The last audit date, which included an opinion by Deloitte certification that the internal controls over all financial reporting, including equity plan disclosures, are operating effectively, was issued with PGE's 2016 SEC form 10-K on February 17, 2017.[11]

Conclusion of No Harm, but Need for Restatement at Time Certain
Staff notes that all parts of the Plan do not now reflect best practices and conventional business thinking. Rather, the Plan is more like a multifaceted machine with certain capabilities no longer used. PGE's actual use of the Plan has been conservative with no use of options. Assuming that continues, reauthorization of remaining shares in the Plan with a replacement date certain does no harm.

This approach allows the Company's Board Compensation Committee time to recalibrate understandings, and to review its current plan and, construct a replacement plan that is well grounded in theory, consistent with benchmarked data, and entirely consistent with forward looking corporate governance. PGE has reviewed this memo and while it does not necessary agree with all its findings or recommendations, PGE does agree with Staff's proposed conditions and reporting requirements.

PROPOSED COMMISSION MOTION:
Reauthorize up to 3,327,146 shares of common stock for the Company's incentive plan subject to the conditions and reporting requirements 1-7 listed below:

1. Authorization Limit:
   Total aggregate common stock issued and sold, or granted under this authority shall not exceed 3,327,146 shares inclusive of shares not meeting vesting requirements and returned for reuse under the Plan.

2. Amendment of Prior Authorization:
   All pertinent prior Commission's Orders are amended and where applicable superseded by the conditions and expectations described herein.

3. Cost Competitive and Effective:

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11 See PGE Response to Staff IR No. 1.

No agent or underwriting commissions are authorized. The Company shall demonstrate in subsequent general rate cases upon request that Company actions under the Plan were reasonably competitive and cost effective.

4. Timely Preparations for Plan Restatement:
   A. The Company will, on or before March 31, 2022, undertake such review, research, and internal decisions as necessary to petition the Commission for review of a fully restated Stock Incentive Plan so as to allow that plan to reasonably take effect on March 31, 2024.
   B. PGE will file a fully reviewed Stock Incentive Plan with the Commission no later than January 5, 2024, requesting review at a public meeting in February of 2024.
   C. Attached to the filing must be PGE's research, findings, summary of deliberations and decisions, and citations of materials relied on in constructing the restated plan. Therein shall be the Company's reasoning for why that plan can be expected to be cost competitive and effective, as well as consistent with prevailing theory and practice.

5. Termination of Authority:
   Authority for granting new awards under the Plan shall expire on March 31, 2024.

6. Reservation of Judgment Regarding Reasonableness:
   The Commission will reserve judgment on the reasonableness for ratemaking purposes of the Company's capital costs, capital structure, and expenses incurred for Plan purposes to future Commission proceedings including but not limited to subsequent general rate cases.

7. Reporting:
   The Company shall notify the Commission and provide a narrative of each Cash Award, and of each element of use of Options under the Plan including granting and execution thereof within 60 days of said activity.