Written Statement of William Y. Tauscher

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Safeway Inc.

to the

Permanent Subcommittee on Investigations

of the

Committee on Homeland Security and Governmental Affairs

of the

United States Senate

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Introduction and Summary

I am William Y. Tauscher, appearing today on behalf of Safeway Inc. ("Safeway" or the "Company"). I have been a member of the Board of Directors of Safeway since 1998 and also a member of Safeway's Executive Compensation Committee since 1998. I served as Chair of the Executive Compensation Committee from 1998 until 2006. Besides being a Safeway director, I am the Managing Member of The Tauscher Group, which invests and assists in the management of enterprises involved with home products, transportation, security and real estate. I am also the Chairman and Chief Executive Officer of Artisoft, Inc. (d/b/a Vertical Communications, Inc.), a public communications technology company. I have previously been Chairman and Chief Executive Officer of Vanstar Corporation, a public computer services company, and before that Chairman and Chief Executive Officer of FoxMeyer, a public nationwide health care distributor. I also have invested in and helped manage several investments with private equity institutional partners.

On behalf of Safeway, I am pleased to accept the Subcommittee's invitation to provide testimony on Safeway's executive stock option compensation practices so that the Subcommittee may examine current tax and GAAP accounting policies in this area. As we understand it, the purpose of this hearing is to review the differences between accounting rules and tax rules in their treatment of stock option compensation. Safeway is not here to advocate for current accounting or current tax policy, or changes in those policies. We adhere to the laws and regulations set by Congress and other bodies and ensure that our financial and tax reporting are of the highest integrity. I do believe, however, that the Subcommittee will benefit from important background and context in evaluating how the current accounting and tax policies for stock option compensation are implemented at a corporation like Safeway.

Safeway is one of the largest food and drug retailers in North America – operating approximately 1,750 stores in the United States and Canada. Our revenues in 2006 were $40.2 billion, and we have about 200,000 employees. It has received national recognition and awards for environmental stewardship, sustainability, social responsibility and leadership in positively impacting the communities it serves through more than $150 million in charitable contributions annually.[1] We received a corporate governance rating of 93.1 from Institutional Shareholder Services, which is intended to convey that our corporate governance is better than 93% of the companies in the S&P 500. The Company has also been instrumental in advancing important public policy discussions. Safeway has recently taken a lead position among American businesses to advance health care reform, building a coalition of nearly 50 large companies. The purpose of the coalition is to offer a comprehensive health care solution by providing coverage for the 47 million uninsured citizens and bringing down per capita costs so that health care is more affordable. Safeway is working closely with its largest union, the UFCW International, which shares these same objectives.[2]

Safeway's Compensation Program

Our compensation program has been instrumental to our success. Safeway's Executive Compensation Committee has designed its compensation program to attract and retain the best management. Our compensation program closely links the compensation of Company executives with the Company's financial performance and substantially aligns that compensation with the long-term interests of stockholders. Because of that linkage, our Board has been able to retain for nearly 15 years one of the best CEOs in corporate America.

Under Steve Burd's leadership, the Company has outperformed 97% of the companies listed in the S&P 500 over the last 14.5 years.[3] The compound annual growth rate of Safeway's stock price over this time period, at 19.8%, has been twice that of the S&P 500. Safeway has outperformed many outstanding U.S. companies during this period, including Intel, Hewlett-Packard, Wells Fargo, Apple and General Electric. From 1992 to 2006, the Company's market capitalization increased from $1.3 billion to $15.2 billion. During that period, the Company's annual net income increased from $43.5 million to $870.6 million, an increase of approximately 2,000%. The Company's annual earnings per share during that period increased from $0.09 to $1.94. These are extraordinary accomplishments considering the maturity of the sector and the nature of its competition. And this has been accomplished while helping the communities we serve by donating or raising more than $1.25 billion in cash or goods, or 18.2% of net income, to charitable organizations.

The Company's recent performance has been excellent. In 2006, the return on an investment in our stock was 47%, about three times the 15.8% return experienced by the S&P 500. An article in Bloomberg News last month noted that Safeway's performance since 2004 was better than 75% of the companies in the S&P 500, and in 2006 was in the 94th percentile.[4] The article went on to point out that Safeway's performance in 2006 was actually twice as good as Safeway's peer group.

The Role of the Compensation Committee

We compete with this peer group of companies and numerous other companies for executive talent, and therefore we need to pay at market levels. The task for the Compensation Committee is to keep an eye on compensation levels at comparable companies and to determine how to reward for extraordinary results. At Safeway, the Committee intentionally sets executive salary levels slightly below market, and uses bonuses and stock options to provide compensation slightly above competitive norms when the Company performs well. Even given the recent success of the Company, Mr. Burd's compensation has been within the lower range of large companies in the United States. His 2006 total compensation ranks in the bottom 10% of companies in the S&P 100, and his equity compensation ranks in the bottom 5% of that group.[5]

Because of the Company's success over the past 10-15 years, Mr. Burd's stock options have increased in value, and he has been rewarded along with other investors in

Safeway's stock. Unlike many other CEOs, Mr. Burd behaves like a long-term stockholder and typically holds his options until the end of the option term – historically, 10-15 years. By doing so, he often misses out on opportunistic peaks in the share price. This practice also causes the options to produce gains at a single point in time, rather than spread out over many years, and these gains may not coincide with a good performing year for the Company. For example, Mr. Burd's 2003 and 2004 option exercises occurred at relatively low price points for the Company's stock. This was not an opportune time to exercise the options, but the term was expiring. When looking at these blocks of exercised options, it is important to consider them as a 10-year compensation instrument and not associate them with one year's performance in the year of exercise.

Much of the criticism leveled at executive compensation these days relates to extraordinarily large severance packages that are given to CEOs upon their departure. Safeway is proud of the fact that none of its executive officers has an employment contract or a severance agreement. The CEO and other executive officers serve at the will of the Board. If our CEO were terminated for any reason, we would have no obligation to pay him any severance. In this respect, Safeway is unusual, if not unique, among large public companies.

Accounting and Tax Treatment

With respect to accounting rules, Safeway adopted SFAS No. 123R, the accounting rule governing the expensing of stock options, in the first quarter of 2005, a year before U.S. companies were required to do so. With the advice of expert independent consultants, Safeway has used the Black-Scholes methodology for valuing options for expense purposes, by far the most commonly used methodology for this purpose. SFAS No. 123R requires a company to value options at the grant date and expense that value evenly over the vesting period. Subsequent to vesting, if the employee has realized a gain from exercising the option, the tax rules require the employee to recognize taxable income at the time of exercise, while the company takes a corresponding tax deduction at that time.

We understand the Subcommittee is examining several issues at this hearing, including how a company's accounting expense for stock options, determined using Black-Scholes or other options valuation methodologies, compares with the tax deductions a company takes when those options are exercised. We have three principal observations on those issues.

First, any evaluation of the accounting expense for stock options should appropriately focus on all option grants, not merely option exercises. A snapshot comparing the accounting expense for exercised stock options to subsequent tax deductions for specific option exercises will result in a distorted picture. For example, such a comparison will not account for the expensed amounts on options that are never exercised because they expire with the exercise price higher than the company's current stock price. Thus, such a snapshot might exaggerate what seems, at first, to be a disparity between the accounting expense and the tax deductions.

Second, the Subcommittee should assess this issue across a broad range of companies. The disparity between accounting expense and tax deductions will be greatest in companies that have outperformed their historical performance. By contrast, the accounting expense may significantly exceed tax deductions in companies that have underperformed their historical performance. A more accurate assessment of this issue requires an examination of numerous companies – outperformers and underperformers.

Third, the Subcommittee should not view the exercise of an option in a particular year as compensation simply for that year. When an option is exercised, the executive will receive the benefit of the appreciation in the value of the company's stock since the grant of the option. This may represent compensation for the executive's service for many years, possibly a decade or more, especially when the executive exercises the option at the end of the option term. The extraordinary growth in Safeway stock value from 1992 through 2006 resulted in a very significant value for options granted early in that period. This extraordinary increase in value is properly viewed as the result of more than ten years of effort to improve stockholder value, and obviously not as compensation for efforts solely in the years of exercise.

To summarize, I hope Safeway's participation today helps illuminate these accounting and tax policy rules for the Subcommittee. Again, we at Safeway offer no view today on what those accounting and tax rules should be in the future. We are committed to diligently following the rules, whatever they may be.

Safeway Executive Compensation Policy and Policies for Stock Options: Additional Detail

A. *Objectives of the Compensation Programs*

Safeway's compensation programs for our executive officers are designed to attract and retain excellent managers, and to motivate these managers to increase the market value of our stock over the long term. In support of these principal objectives, the compensation programs are designed to:

- Provide our executives with base salaries, retirement and other benefits that are competitive with those provided by other companies with whom we compete for executive talent;

- Pay annual bonuses that reward our executives for the attainment of our annual financial, operational and strategic goals;

- Grant our executives equity-based compensation that will motivate them to improve our long-term performance and, specifically, to increase the market value of our stock price over time, in addition to helping retain those executives; and

- Motivate our executives to improve their individual performances.

Our executive salaries at Safeway are slightly below the median for comparable companies, but executives can make slightly above the median if the Company outperforms its peers. We place great emphasis on the objective of improving corporate performance and thereby increasing the long-term market value of our stock. We believe these policies help align the interests of our executives with those of our stockholders, and advance our objective of increasing stockholder returns.

B. Stock Options.

We believe stock options provide an incentive for our employees to increase the long-term market value of the Company, as represented by its stock price. Prior to 2005, the Company granted stock options periodically, such as at the time of hire or promotion, or for retention purposes. Today, we have an annual grant program under our Long-Term Incentive Plan ("LTIP"). As in many other companies, the purpose of our LTIP is to encourage our executives to improve the long-term value of the Company, while also serving as a method for retaining our executives. Our LTIP involves annual grants of stock options to our eligible employees. Compared to other LTIP programs that may involve a mix of cash and equity vehicles, we believe our stock-option-based LTIP most effectively focuses long-term performance on the objective of share price appreciation and aligns the interest of management with that of the stockholders.

Under the LTIP, the Compensation Committee makes annual grants of stock options based upon various factors, including the employee's base salary, competitive levels of long-term incentive compensation and Company performance over the last several years. Examining competitive data ranges of compensation levels around the median peer group level, using the Black-Scholes value of Company stock options and taking into account recent Company performance, the Compensation Committee determines appropriate amounts of long-term incentive compensation to be paid to the employees.

The Compensation Committee, or the Board, has the sole authority to make stock option grants to executive officers. The Committee generally will authorize grants to such officers only at a meeting, and the option grant dates selected will be no earlier than the date of the meeting. Earlier this year, the Compensation Committee approved LTIP option grants to Safeway officers at a meeting in February, and it selected as the option grant date the first day of our insider trading window period following the meeting, which occurred later in February.

<u>Mr. Burd's Compensation and Stock Options</u>

The base salary of Steve Burd, our Chief Executive Officer ("CEO"), is determined annually by the Board of Directors. At the end of each fiscal year, our Lead Independent Director collects information regarding Mr. Burd's performance and discusses relevant issues with him. The Lead Independent Director then reports on his or her findings and discussions to the Compensation Committee, which reviews Mr. Burd's

salary each year. The Compensation Committee periodically obtains information regarding the compensation of the chief executive officers of our peer group companies. The Compensation Committee then meets, without Mr. Burd present, and makes a recommendation to the Board about Mr. Burd's base salary for the next fiscal year. The Board subsequently meets in executive session, without Mr. Burd present, and conducts a formal performance review of Mr. Burd, and sets his base salary for the next fiscal year. Other regular elements of compensation for Mr. Burd – bonus levels and long-term incentive equity award grants – are also established by the Compensation Committee and the Board in conformity with our general compensation principles. During the years 2001-2004, Mr. Burd did not receive any stock option grants. In 2002 and 2003, Mr. Burd received no bonus under the Company's Operating Performance Bonus Plan. In 2003, he elected to forgo his bonus under the Company's Capital Bonus Plan.

Last month, Graef Crystal, a respected compensation consultant, wrote an article for Bloomberg News praising Safeway's and Mr. Burd's performance and discussing Mr. Burd's compensation as compared to that performance.[6] The article indicated that in light of the fact that Mr. Burd "help[ed] [the Company's] stock deliver a 47% return in 2006" "investors get Safeway['s] CEO for sale price." The report noted that Safeway's performance since 2004 was better than 75% of the companies in the S&P 500 index, and in 2006 was in the 94th percentile. The article then noted: "[f]or that fabulous performance, Mr. Burd was paid well, but, comparatively speaking, not that well. His total remuneration . . . was 39% below the competitive standard based on 438 companies with market values of US $3 billion or more" and 22% below the Company's peer group, despite performance that was approximately twice as good. The article also praised Mr. Burd's and the Company's good performance and Mr. Burd's below-market compensation package in prior years as well. It also commented favorably on Mr. Burd's Safeway stock holdings. Mr. Burd currently holds more than 460,000 shares of Safeway stock, giving him a large stake in the future success of the Company.

Mr. Burd was granted options in 1992, when he joined the Company, and in 1994, shortly after he became CEO. Mr. Burd exercised a small fraction of the 1992 options and all of the 1994 options 10 years later, in 2002-2004. At the time of exercise, the 1994 options were at or near expiration. Had Mr. Burd exercised these options in earlier years, his gains could have been significantly higher, but his general practice was to hold the options until near the expiration dates. This practice caused him to exercise many of his options in 2003 and 2004, when the Company's stock price was relatively low. Nevertheless, at the time of exercise – roughly ten years after the grants were made – Mr. Burd's options had gained considerable value. As explained above, since 1992, the Company has performed extremely well. The value of Mr. Burd's options resulted from the Company's performance over that entire span of years during which Mr. Burd led and managed the Company. It would not be appropriate to consider the gains on these options as "compensation" only for the specific years in which they were exercised.

Statement of Financial Accounting Standards No. 123R and Black-Scholes

Safeway applies U.S. generally accepted accounting principles for purposes of reporting stock option compensation expenses in the Company's financial statements. Prior to 2005, the Company's stock option compensation expense was determined under APB Opinion No. 25, Accounting for Stock Issued to Employees. In general, no stock option compensation expense was reported by the Company for stock options subject to APB Opinion No. 25 because the per share exercise price of the stock options was the fair market value of the stock on the grant date of the stock option.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R. The Company elected to early adopt SFAS No. 123R in the first quarter of 2005. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options after January 1, 2005, to be recognized in the financial statements as compensation cost based on the fair value on the date of grant. Safeway determines fair value of such awards using the Black-Scholes stock option pricing method. An independent third party assists the Company in determining the Black-Scholes assumptions utilized in the valuation of stock options.

Under SFAS No. 123R, Safeway reports stock option compensation expense for all options granted based on the vesting period of the stock option. The stock option compensation expense for a period equals the portion of the fair value attributable to the portion of the stock option that vests during the period. For example, currently the Company's stock options generally vest over a five year period at the rate of 20% on each anniversary of the grant date of the stock option. In the case of a stock option subject to SFAS No. 123R, 20% of the fair value of the stock option on the grant date is reported as stock option compensation expense each year of the vesting period. This stock option compensation expense is reported without regard to the fair value of the stock option during the vesting period, and without regard to whether the stock option is ever exercised. This stock option compensation expense is reported even if the exercise price exceeds the Company's stock value when the stock option vests (and thus has no value to the employee).

Comparing Hypothetical Expensing of Options granted in 1992-94 with Tax Deductions taken in 2002-04

Accounting principles and tax laws have different objectives and often treat the same items differently. For example, stock options, depreciation, pension expense, asset impairment and workers compensation – to name a few – are all treated differently for accounting and tax purposes.

Black-Scholes is one of the most popular methodologies for valuing stock options at the date of grant. However, no methodology will necessarily assign a value to a stock option grant that equals the amount of the tax deduction relating to the exercise of the stock option. Key inputs to Black-Scholes and other valuation methodologies are current stock price and historical stock performance. Companies that perform better in the future

than they have in the past will likely have greater tax deductions than accounting expense. Conversely, companies with declining performance will probably have greater accounting expense than tax deductions. The eventual tax deduction received by companies for option grants is highly dependent upon stock price performance, so at the time of award, it would be impossible for the regulators to assess the tax deduction received by Safeway. Presumably, accounting expense and tax deductions will be approximately the same given a large enough sample of companies and if all options are measured, not just exercised options. In evaluating the accounting expense methodologies under SFAS No. 123R, we urge the Subcommittee to review a broad range of data for many companies before reaching any conclusions. In particular, such an examination should include within its scope both options exercised and options granted and expensed but not exercised. Only by looking at the entire range of options granted for an appropriate sample of companies can an appropriate evaluation be done.

We understand that the Financial Accounting Standards Board (FASB) considered and rejected accounting for stock options in a manner similar to the tax treatment. The FASB believed that the value of options should be measured when all of the terms of the options are set rather than when the options are exercised.

Conclusion

Thank you once again for the opportunity to provide our views on these issues. I hope this material has been useful to the Subcommittee.

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[1] The Company has received a number of awards in recent years in recognition of its social and environmental commitment and efforts, including, but not limited to: *Catalyst Award*, presented annually to three companies for initiatives that advance women in the workplace; *Red Cross – Circle of Humanitarian Award,* presented for raising $3 million for the South Asian Tsunami relief effort; *Easter Seals Chairman's Corporate Roundtable Award*, presented for raising $1.6 million for Easter Seals and its local affiliated agencies, which serve people with disabilities and their families; *Project Open Hand – Most Outstanding Partner Award*, presented for its record of assisting Project Open Hand, which provides home-delivered hot meals to AIDS victims and the homebound in the San Francisco Bay Area; *Green Power Leadership Award*, presented for the Company's leadership in purchasing wind energy to power a range of different stores and fuel stations in the United States; and the *Proggie Award*, presented by the People for the Ethical Treatment of Animals for the Company's requirement that its private label suppliers not use animal testing in the manufacture of cosmetics or household goods.

In addition, since July 2002, Safeway has been included in the Domini 400 Social Index maintained by KLD Research and Analytics, Inc. To be included in the Domini 400 Social

Index, companies must exhibit positive records with regard to the environment, community relations, human rights, product quality and safety, diversity, employee relations and corporate governance.

Safeway is also an industry leader in philanthropy. During 2006, the Company donated more than $110 million worth of merchandise to food banks and various hunger-relief agencies, bringing the Company's total food donations over the past decade to more than $1 billion. In 2006, the Company also contributed $22 million to schools through educational programs. In addition, the Company has donated a combined $22.3 million through major fundraising campaigns to support breast and prostate cancer research, treatment and education and to further the important work of the Muscular Dystrophy Association and Easter Seals.

The Company maintains Diversity Advisory Boards in each of its operating areas whose mission is to recognize, celebrate and benefit from the uniqueness of each employee and customer, to value, respect and support these differences in the workplace and to reflect this diversity in the communities we serve. In early 2007, the Company was featured in *HR Magazine's* cover story as a corporate innovator in diversity efforts to help develop and elevate women within the Company.

[2] The Coalition to Advance Healthcare Reform (CAHR), chaired by Steve Burd, is an active working coalition of more than 50 businesses, employers and other like-minded leaders committed to reforming the nation's healthcare system by 2009. Through this newly formed organization, the business community is joining together with other leaders and organizations to advance meaningful, market-based solutions to our nation's healthcare crisis. By advancing a set of core principles to guide and shape policies, the coalition can be instrumental in helping advance solutions that reverse rising healthcare costs, solve the problem of the uninsured and dramatically improve the quality of care for every American. More information about CAHR can be found at www.coalition4healthcare.org.

[3] Based on the compound annual growth rates for the S&P 500 index since October 13, 1992. Safeway was included in the S&P 500 index beginning in November 1998.

[4] *Safeway Shareholders Underpay for Star Performer,* Graef Crystal, Bloomberg News (May 14, 2007).

[5] As reported in 2007 proxy statements by companies using the new SEC disclosure rules, and whose CEOs were in office for all of 2006. With those qualifications, the sample group consisted of 78 companies.

[6] Id.