MONTANA-DAKOTA UTILITIES, CO.
A Division of MDU Resources Group, Inc.

Before the Public Service Commission of North Dakota

Docket No. PU-17-295

Rebuttal Testimony
of
James E. Kaiser, SPHR and SHRM -SCP

Q. Would you please state your name and business address?

A. Yes, my name is James E. Kaiser. My business address is 400 North Fourth Street, Bismarck, North Dakota 58501.

Q. What is your position with MDU Resources Group, Inc.?

A. I am the Director of Human Resources.

Q. What are your duties and responsibilities?

A. I am responsible for the strategic direction and administration of all disciplines in the Human Resources (HR) department including compensation and benefits, talent acquisition and development, labor and employee relations and governmental compliance with employment and employee relations for Montana-Dakota Utilities Co. and Great Plains Natural Gas Co.

Q. Would you please outline your educational and professional background?

A. Yes. I have a Bachelor's Degree in Business Administration with a concentration in Human Resource Management from the University of North Dakota in Grand Forks, ND. I have worked my entire 35-year career

118 PU-17-295 Filed 03/23/2018 Pages: 20
Prefiled Rebuttal Testimony of Mr. James E. Kaiser
Montana-Dakota Utilities Co., a Division of MDU Resources Group, Inc.

in Human Resources in the utility industry; I joined Montana-Dakota in 2002 and have held a variety of positions of increasing responsibility within the Human Resources Department. I hold senior professional certifications from the Human Resource Certification Institute and the Society for Human Resource Management. My most recent job change was to move into the role of Director, Human Resources in July 2013.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to the testimony of Dante Mugrace, testifying on behalf of the North Dakota Public Service Commission Advocacy Staff, regarding incentive compensation which Montana-Dakota considers the at-risk-pay component of Montana-Dakota's total cash compensation. In particular, I am responding to Mr. Mugrace citing Case No. PU-10-124 as a basis to eliminate 60% of the amount included in this case for incentive compensation. There was a settlement that was reached in that case and at no time during those discussions did Montana-Dakota agree that an arbitrary reduction was justified. My testimony will explain changes made to the Incentive Plan in 2017 and the Company's process by which it sets total rewards which includes incentive compensation as the at-risk component of total cash compensation.

Q. Please describe Montana-Dakota's Utilities Co.'s (Montana-Dakota's) general approach to setting total rewards for employees.

A. There are three basic principles underlying Montana-Dakota's approach to employee compensation—all designed to minimize costs while allowing the Company to attract and retain the qualified employees required to deliver safe and reliable gas and electric service to our customers.

First, Montana-Dakota has adopted a Total Rewards philosophy. This approach requires that we view base pay and incentive compensation as the two key components of total cash compensation. Total cash compensation (base pay and at-risk incentive compensation) along with benefits, as a total package make up the Total Rewards philosophy. This philosophy guides how the Company compensates employees.

Second, Montana-Dakota makes every attempt to compare company wages and at-risk incentive compensation with the relevant labor market and set total cash compensation at the market average. We are finding that the market for employees with the skills and experience we require is very competitive in the areas we conduct business. For that reason, the two components of cash compensation we offer must provide the same general pay levels and benefits in our total rewards package as are included in the packages provided by the Company's competitors for labor.

Third**,** the Company believes that, to help encourage employee engagement and better understand the importance of operating our business effectively, a certain percentage of each employee's market compensation should be “at risk.” Accordingly, under the Company’s incentive plan, each employee has the opportunity to receive total cash compensation and benefits at the market average, so long as the employee performs at an acceptable level. However, employees will earn less than the average remuneration when performance is less than acceptable and, conversely, will earn higher than the average remuneration when performance is exceptional. Importantly, however, our program is structured such that total compensation to all employees is aligned with the market average.

Q. How does the Company determine the market average when it sets the base pay and incentive compensation components of total cash compensation?

A. When market pricing a position within the organization, we pull data from several survey and online sources to gather data. We then analyze the median base pay and target incentive compensation to determine a market average.

Q. Are incentive plans an appropriate part of compensation?

A. Yes. We continue to monitor and research incentive pay. According to a 2017 American Gas Association Compensation Survey for the North Central Region thirteen of the fifteen participating utilities provided incentive compensation or pay at risk to all levels of employees as shown in the summary provided in Exhibit No.__(JEK-1). Based on this ongoing research, incentive compensation remains strong in the workplace and in the utility sector.

Q. Does Montana-Dakota have alternative means of maintaining adequate compensation without the use of incentive or at-risk compensation?

A. In the absence of incentive compensation, the only viable alternative for Montana-Dakota is to increase fixed costs in the form of base pay to keep total cash compensation competitive in the labor market and retain a qualified work force. Base pay is the most expensive way to compensate employees because other benefits such as the Company's 401K contributions are calculated as a percentage of base salary. Benefit cost increases lead to additional costs for the utility and ultimately for customers. For this reason, it is important to have a reasonable balance of base pay and incentive (at-risk) pay to stay competitive in the labor market while still controlling costs.

Q. Do you have additional processes in place to ensure that the Company is not paying or incentivizing more than the minimum necessary to attract and retain a qualified workforce?

A. Yes. Periodically the Company contracts with an outside independent consultant to review compensation programs and practices. For instance, in 2013, the Company contracted with Aon Hewitt to provide a third-party review of base compensation and incentive compensation. This independent review will be done again in 2018 to assure appropriate levels of base pay, incentive compensation and benefits are available to attract and retain talent required to provide safe and reliable service to our customers.

Q. What was the result of the 2013 Aon Hewitt review?

A. The Aon Hewitt review indicated Montana-Dakota's compensation programs, including incentive programs, are well designed and utilize high quality and established external survey sources to ensure the programs align well with other utilities and industries that compete for the same types of employees. Aon Hewitt also found that employees' eligibility for incentive pay is consistent with other utilities, and that the plan metrics include a significant and appropriate portion of incentive compensation focused on customer service and cost management. The results of the Aon Hewitt study are provided in Exhibit No.__(JEK-2).

Q. Do you agree with Mr. Mugrace's testimony, Page 11, Line 14 that incentive compensation should be reduced by 60% as he references Case No. PU-10-124?

A. No, Case No. PU-10-124 was an agreed upon black box settlement made up of several items. In the case of settlement, it is not relevant as it does not mean that all parties agree on the give and take that occurs to resolve a case.

Q. Do you agree with Mr. Mugrace's testimony, Page 11, Line 18 that ratepayers should not be required to pay incentive compensation costs because they do not provide any benefits to them?

A. No, the Company stands behind its philosophy that having a portion of total cash compensation at-risk creates a desire within employees to do a better job and to focus on the areas of the business that are within their control such as controlling costs, providing outstanding customer service, and training and developing the workforce.

Q. Did the plan design for Montana-Dakota's 2017 Employee Incentive Plan change from the design of the 2010 Employee Incentive Plan?

A. Yes, in 2010 company earnings was a goal employees were paid out on if the goal was achieved. In 2017 the plan design was changed, and employees are only paid out on satisfactory achievement of the customer service and operations and maintenance goals.

Q. Did Montana-Dakota achieve all the goals outlined in the 2016 and 2017 Employee Incentive Compensation Plans?

A. Yes, 2016 goals achieved were available at the time this case was filed. 2017 plan results were available in February 2018 and Montana-Dakota achieved both goals which are focused on customer service and operations and maintenance expense.

Q. Would you describe the third component, the benefits that are available to employees?

A. Yes, employee benefits are the third part of the Total Rewards package. The Company offers standard health and welfare plans (medical, dental and vision insurance; vacation and other paid time off benefits; and life, disability and accident insurance); along with a retirement savings plan. Employees share premium costs for many of these benefits.

Q. What benefit does the Total Rewards Package provide its North Dakota customers?

A. The Total Rewards philosophy is cost effective for the Company and customers because it provides a means to control costs while continuing to attract and retain the work force necessary to provide safe and reliable service to its customers.

This competitive total rewards philosophy is key to maintaining the highly skilled workforce required to operate and maintain the utility which directly benefits our customer base because it ensures we have qualified people performing the work of providing a safe and reliable system for our customers. It is prudent and beneficial to customers to leverage all three components of our Total Rewards Philosophy to minimize turnover.

Q. Does this complete your testimony?

A. Yes, it does.

Policies and Practices

Bonuses and Other Variable Pay Programs (continued)

BONUS AND/OR OTHER VARIABLE PAY PROGRAM(S) IN WHICH SOME OR ALL INCUMBENTS ARE ELIGIBLE (continued)

	% of Organizations with at Least One Plan	# of Responses	Prevalence of Various Plan Types (as a % of Organizations with Plans)						
			Bonus	Current Cash Profit Sharing	Team/Small Group Incentives	Individual Incentives	Spot or Technical Achievement Awards	Gainsharing	Other Short-Term Incentives
REGION									
Northeast									
Executive	92.3%	13	83.3%	0.0%	16.7%	33.3%	0.0%	8.3%	8.3%
Management, Excluding Executives	92.3%	13	83.3%	0.0%	8.3%	33.3%	25.0%	0.0%	8.3%
Exempt, Non-Management	91.7%	12	90.9%	0.0%	9.1%	36.4%	36.4%	0.0%	9.1%
Nonexempt	84.6%	13	81.8%	0.0%	18.2%	36.4%	36.4%	0.0%	18.2%
Southeast									
Executive	61.5%	13	87.5%	0.0%	12.5%	50.0%	37.5%	0.0%	0.0%
Management, Excluding Executives	61.5%	13	87.5%	0.0%	25.0%	50.0%	37.5%	0.0%	0.0%
Exempt, Non-Management	61.5%	13	87.5%	0.0%	25.0%	37.5%	50.0%	0.0%	0.0%
Nonexempt	61.5%	13	87.5%	0.0%	25.0%	37.5%	50.0%	0.0%	0.0%
North Central									
Executive	86.7%	15	100.0%	15.4%	7.7%	30.8%	30.8%	7.7%	0.0%
Management, Excluding Executives	86.7%	15	100.0%	15.4%	23.1%	46.2%	61.5%	7.7%	0.0%
Exempt, Non-Management	86.7%	15	100.0%	15.4%	23.1%	46.2%	61.5%	0.0%	0.0%
Nonexempt	86.7%	15	92.3%	15.4%	30.8%	38.5%	61.5%	0.0%	0.0%
South Central									
Executive	85.7%	7	83.3%	16.7%	0.0%	33.3%	0.0%	0.0%	0.0%
Management, Excluding Executives	85.7%	7	83.3%	0.0%	0.0%	50.0%	33.3%	0.0%	0.0%
Exempt, Non-Management	85.7%	7	83.3%	0.0%	0.0%	50.0%	33.3%	0.0%	0.0%
Nonexempt	85.7%	7	83.3%	0.0%	0.0%	33.3%	33.3%	0.0%	0.0%
West Coast									
Executive	100.0%	5	100.0%	0.0%	0.0%	20.0%	20.0%	0.0%	0.0%
Management, Excluding Executives	100.0%	5	100.0%	0.0%	0.0%	20.0%	60.0%	0.0%	0.0%
Exempt, Non-Management	80.0%	5	100.0%	0.0%	0.0%	25.0%	75.0%	0.0%	0.0%
Nonexempt	80.0%	5	100.0%	0.0%	0.0%	25.0%	75.0%	0.0%	0.0%

Performance, Reward, & Talent
Consulting

Compensation Program Audit—Summary of Findings

MDU Utilities Group and Great Plains Natural Gas Co.

January 6, 2014

Compensation Program Audit—Summary of Findings

Background

Montana-Dakota Utilities Co. (MDU) and Great Plains Natural Gas Co. (GPNG) (which are part of MDU Resources Group, Inc. (MDU Resources)) engaged Aon Hewitt to conduct a compensation program audit. The audit covered compensation policies and programs in place for employees in grades 29 through 42. The audit included a review of the compensation philosophy and structure to ensure the approaches to the salary structure and ranges, the methodology used to classify jobs, and the incentive compensation plan design are "Reasonable" in light of common practices within the utility industry and among general industry companies. This document summarizes the findings from the compensation competitive analysis and presents our recommendations.

Approach

We began the compensation audit by learning about MDU and GPNG's current compensation programs through discussion and document review. MDU and GPNG sent plan information, incumbent data, and market data for all relevant positions. We held a number of teleconferences with the Human Resources team to discuss program details and address questions to ensure a clear and thorough understanding of MDU and GPNG's practices. We reviewed the current process for market pricing and compared the incumbent data to the market data to assess the competitive positioning of the organization.

Executive Summary

MDU and GPNG's compensation programs overall are sound and well designed. They are maintained and updated in an effective, timely, and professional manner. As will be described in this material, the programs are anchored on the use of high quality and established external survey sources. This is not to suggest that there are not suggestions for modification or improvement. In this section, we highlight the key recommendations that have surfaced to us during the course of our analysis. Additional detail on each point is contained in the following pages. The majority of these recommendations relate to process or technical issues. There were not any major deficiencies that we became aware of during the course of our work. Our recommendations include:

- The Total Compensation/Reward Statement of Philosophy/Strategy should be updated and expanded, including defining a specific Target Total Cash position;
- Consider purchasing the Towers Watson benchmark surveys, especially for the utility sector;
- Consider moving salary structures slightly more aggressively than in the past. We understand that given the recent economic downturn, there has been pressure to slow the structure adjustments, however, which has helped manage pay increases across MDU Resources over the past few years. To keep MDU and GPNG from falling below market competitive levels, this practice of slowing structure adjustments will need to be discontinued;
- Consider balancing the maximum pay opportunity in the Incentive Plan design between the Senior Management and Employee Plans;
- Confirm the desired degree of stretch in the Incentive Plan goals at target; and
- Examine jobs which are "off market" (either high or low) for potential pay grade adjustment.

Findings

Total Rewards Strategy

Current Practice

MDU and GPNG's Total Rewards Strategy is documented in their "Total Rewards Philosophy" dated July 23, 2012. In this documentation, MDU and GPNG state that base salary is targeted at the 50th percentile of "our competitive labor market." In practice, the "competitive labor market" is the national general industry market. Benefits and Work Culture and Incentive Compensation are also mentioned in the Total Rewards Philosophy as part of an overall package delivered to employees at a level necessary to attract and retain talent.

While not explicitly addressed in the Total Rewards Philosophy, the following items are also included in the Total Rewards Strategy:

- Employees that move to a lower paying grade due to corporate interests will not receive a reduction in pay (these employees are "redlined," and pay is managed on an exception-basis outside the existing salary structure). However, an employee that voluntarily elects to move to a job in a lower pay grade will have their salary reduced and managed within the salary structure guidelines.
- MDU and GPNG's focus is on targeting median ***base salary***. MDU and GPNG do not specifically target any particular pay level for total target cash.
- Significant differences in competitive pay due to location (e.g., Williston district) are managed through the Labor Market Retention Incentive Program and Monthly Location Allowances.

Observations and Recommendations

MDU and GPNG's "Total Rewards Philosophy" document is well-suited as a communication piece to be used with employees to inform them of the overall strategy in general terms. However, MDU and GPNG would be better served with an additional, more robust document that clearly addresses all elements of the total reward strategy in greater detail to serve as a Human Resource tool for assessing the validity of current programs. We suggest the following additions/clarifications to this more-expansive document:

- Identify what level of competitive targets (e.g., 50th percentile) are targeted for Benefits and Work Culture;
- Address the strategic use of special recognition and retention awards, as well as location allowances;
- State the role and purpose of each element within the total reward spectrum;
- Identify the desired level of visibility or transparency MDU and GPNG's reward program is intended to have with employees;
- Identify roles and responsibilities to administering and maintaining the various Total Rewards programs; and
- Define the specific peer group(s) and/or characteristics used when performing benchmarking and competitive assessments.

Most importantly, MDU and GPNG currently do not target a specific level of Total Target Cash as part of its Total Rewards Strategy. We suggest beginning to track and target a defined Total Target Cash position, and communicating the practice in the Total Rewards Strategy documentation.

AON Hewitt

Data Sources

Current Practice

MDU and GPNG use the following sources for market pricing jobs:

- Mercer Total Compensation Survey for the Energy Sector
  - Field/Hourly
  - Cross Segment
  - Upstream and Midstream
  - Utilities
  - General Benchmark
- US Mercer Benchmark Database—
  - Logistics and Supply Chain
  - Finance, Accounting, and Legal
  - Human Resources
- Mercer/Gartner Information Technology Compensation Survey
- American Gas Association Compensation Survey
- EAPDIS, LLC Energy Technical Craft Clerical Survey
- Milliman Northwest Utilities Salary, Wage, & Benefits Survey

Observations and Recommendations

All these surveys are well established, consistently-produced surveys with broad participation that provide market data for a wide range of positions among both general industry and the energy sector.

It is MDU and GPNG's standard practice to market price jobs using ***national*** general industry data. This practice is part of a growing trend in the utility industry. We support this approach for non-utility-specific roles at MDU and GPNG, given that they recruits from and loses talent to general industry for these roles. However, we do recognize that the market pay level for these roles based on utility industry data tends to be higher than market data based on general industry. As such, MDU and GPNG have established a conservative approach to measuring the market for non-utility specific roles.

MDU and GPNG does not apply geographic differentials to the national market data. Based on ERI's Geographic Assessor and Pay Survey, cost of labor ranges from 90% to 110% of the national average in locations where the Utility Group has employees. Cost of labor for locations in Washington State tends to be about 110% of the national average. Cost of labor in locations in Idaho, Montana, and Minnesota are approximately 90% of the national average. Cost of labor in North Dakota (particularly the Williston District) is rapidly changing and quickly on the rise, especially for utility-specific roles. Use of geographic differentials is more reflective of an organization that is placing greater emphasis on equity and internal talent mobility than on cost management. Given MDU and GPNG's population, we support MDU and GPNG's decision not to apply geographic differentials and manage significant outliers to the market (e.g., Williston District) through focused allowance programs.

Whenever possible, we strive for a minimum of two survey matches to market price a role. MDU and GPNG may consider purchasing the Towers Watson Middle Management, Professional, and Support Compensation Survey for both General Industry and the Energy Services sector to supplement their existing surveys to increase the likelihood of having multiple matches for market pricing purposes. Many of our utility clients utilize this source of data for its breadth of roles and broad participation. The existence of an additional survey source will lend greater stability over time to the market data and provide for an additional “cross-check” within a given year.

Salary Structure Review

Current Practice

MDU Resources Group, Inc. (the parent company) employs a single salary structure for all non-union, non-executive employees at all business units under the corporate umbrella and is managed by the corporate HR team. Each business unit provides market data to corporate HR to assist in the process. No separate (premium/discounted) structures are used for certain job families. As discussed above, retention and location allowances are used to manage significant location differentials.

The structure consists of 14 grades with a 50% range spread. The structure is set based on market pricing results and is reviewed and updated annually. Market pricing data used to build the structure is aged to July 1. The structure is designed to be ahead of the market at the beginning of the year, meet the market in the middle of the year, and begin to fall off the market through the remainder of the year.

Observations and Recommendations

MDU and GPNG follow a traditional process for developing and managing the salary structure. The number of grades and the range spread are within typical market practice and seem to work effectively for MDU and GPNG. It is becoming more common to place both exempt and non-exempt roles on the same structure to support a message of inclusiveness. We believe the use of a single exempt/nonexempt structure should be continued. In addition, since the application of FLSA exemption criteria is performed on a job-by-job basis rather than a by-grade basis, renders the blending of both non-exempt and exempt roles in the same grade of little consequence.

The range spread of 50% is a bit narrower than the more-common 60% spread we have seen over the past several years, especially for higher level professional and management level roles. Given current pay distribution/dispersion within grades, there is no compelling need to widen the ranges simply to accommodate an external trend.

Since market pricing is the basis for deriving midpoints for the corporate pay structure, the midpoint progression is not consistent across all grades. However, the average progression is about 15%. Midpoint progression at the higher grades (38-42) is narrower (12%-14%) as compared to the lower grades where the midpoint progression can reach up to 17%. This degree of variability is inverted from expected practice but again not concerning to us given the context of the salary structure development and the distribution of salaries within the ranges. We feel these nuances do not detract from the viability of the MDU and GPNG’s overall salary structure.

AON Hewitt

We understand that jobs in grades 41 and 42 at MDU and GPNG are comparable in base wage to officer-level roles in other groups in the corporation. This is managed by placing the officer-level roles in the letter-graded executive structure and having MDU and GPNG officers enter that same structure at a high grade, avoiding compression issues at these levels. While this practice is currently effective in managing compression, as salaries increase MDU and GPNG will need to pay close attention to ensure that there is sufficient differentiation between grades in both the numerical and letter-graded structures.

MDU and GPNG also faces compression challenges between selected bargained and non-bargained populations. In particular, MDU and GPNG's challenge involve pay for a senior line technician (a bargained employee eligible for overtime) and the shift supervisor responsible for overseeing the line technician's work (a non-bargained employee ineligible for overtime). Depending on the level of overtime earned, the line technician could earn more compensation than their direct supervisor. We typically suggest addressing compression issues at these levels in one of three ways: (1) offer overtime to the non-bargained supervisor; (2) create a premium structure for the supervisory role; or (3) do nothing formal in terms of structure or premiums and manage the imbalance in compensation informally (as long as the company is able to fill the supervisory role with qualified employees). MDU and GPNG currently addresses the issue by managing pay for the supervisor so that these employees are positioned high in the appropriate grade of the current structure. This is a variation of the third option above. In fact, provided that taking this approach is sufficient to address recruiting/promotion and retention issues, it is preferred because it avoids the need to create and administer premium structures.

MDU and GPNG's salary structure midpoints compare favorably to the market in that they are at 95% of the market values for the priced jobs. To the degree that they may be adjusted for annual market movement, the gap would narrow further at the next adjustment cycle. In as much as the market data is also reflective of national pay levels, MDU and GPNG's salary grade midpoints are positioned appropriately given its compensation strategy.

Note: *It is important to understand the methodology involved and the implications of incumbent weighted versus job weighted calculations in the findings. Our analysis compared the midpoint for each job to the market for each job regardless of the number of incumbents in each job. As will be discussed in the section on Competitive Positioning, this relative position can be significantly influenced by the number of incumbents if the calculations are performed on an incumbent weighted basis and there are jobs with high numbers of incumbents as is the case with MDU and GPNG.*

Salary Increase Process Review

Current Practice

MDU Resources Group, Inc. (the parent company) annually determines the salary structure adjustments for the entire organization, and each business unit sets the salary increase budget for the respective unit. The budget and the process for determining individual increases are consistent across the business units.

Individual salary increases are determined using an allocation matrix based on performance rating and compa-ratio. All employees receiving outstanding performance ratings are eligible for merit adjustments. All employees falling below expectations are ineligible for merit adjustments. Those falling in the middle of the range for performance ratings are eligible for merit adjustments, except for those with the highest compa-ratios (those individuals are eligible for lump sum payments in lieu of merit adjustments).

MDU Resources has been conservative on adjustments to its salary structure in recent years. This has largely been driven by an attempt to manage pay across a range of business units whose performance has varied in recent years (some business units have struggled and been unable to deliver salary increases to their employees, while MDU and GPNG have performed well and been able to deliver increases). Those business units with small or zero merit increase pools have been reluctant to increase their salary structures without accompanying salary increases. This practice, while effective at preserving compa-ratios, results in an under-competitive salary range which may be difficult to “catch up” over time.

Observations and Recommendations

The approach for providing annual salary increases is sound. The budget is based on market practice and corporate affordability. Historically, MDU and GPNG’s salary increases have been equal to or slightly below Energy Services companies in the market (based on Aon Hewitt’s Salary Increase Survey results from 2008–2013).

MDU and GPNG has stated that their current overall compa-ratio is “slightly above 1.00.” This seems accurate to us as the compa-ratio that we calculated for the *priced jobs* in our analysis is .98. A variance of this magnitude given the additional employees covered by non-priced jobs is not unexpected and does not change our findings. Providing salary increase budgets consistent with market adjustments and using the allocation guidelines as described above will help to manage the compa-ratio and bring it closer/maintain its position relative to 1.00 over time.

We recognize that MDU Resources has intentionally adjusted their structures at a slightly under competitive pace (as discussed under “Current Practice”). However, the fact that the midpoints for the Utility Group are at 95% of market suggests that the midpoint adjustments should continue at (or perhaps slightly exceed) market range adjustments for a period of one to three years. This would bring the midpoints more in line with the desired pay opportunity. It is important to note that we are not suggesting that the salary increase budget and the structure adjustment should be the same percentage. Rather that structure adjustments are usually .5% to 1.0 % lower than the annual increase budget and this variance should be reduced but not eliminated. Therefore, a variance of .25% to .5% might be considered.

Incentive Compensation Program Review

Current Practice

We reviewed two incentive programs currently in place for non-executive utility employees. They are the Employee Incentive Plan and the Senior Management Incentive Plan. Eligibility for participation in the plans is defined as all regular, non-executive employees compensated for 1000 or more hours.

The plans are very similar to each other. Other than eligibility and target award size, the primary difference between the plans is the leverage curve. The Senior Management Incentive Plan provides the opportunity to earn up to 200% of the target bonus opportunity, while the Employee Incentive Plan’s maximum payout opportunity is 150%.

Both plans utilize the same metrics, albeit with different Financial and Operations and Maintenance target goals for each company. A minimum financial achievement for the Company Financial Goal must be met before any payout can be earned. If the Company Financial Goal falls below threshold level, no bonus award will be earned. If either the Operations and Maintenance or Customer Service Satisfaction Goal fail to be met, only the associated portion of the bonus opportunity will not pay out.

AON Hewitt

Both the Company Financial and Operations and Maintenance Goals are numerical goals set at the beginning of the measurement period. The Customer Service Satisfaction Goal is based on performance in the JD Power and Associates customer service survey.

The Senior Management Incentive Plan, which covers grades 41 and 42, has some overlap with the MDU Resources Group, Inc. Executive Incentive Plan and Management Incentive Plan. These plans cover a separate grading structure for executives at MDU Resources. MDU and GPNG follow a different practice than other business units under MDU Resources. Employees that typically fit in grades B and C at MDU Resources are placed in grades 41 and 42 if they are employed by a Utility company. The incentive compensation target opportunities for grades 41 and 42 are 15% and 20% of base salary, respectively. The target incentive compensation opportunities for grades B and C are 15% and 20%, respectively. Furthermore, the maximum payout opportunity under the Senior Management Incentive Plan of 200% mirrors the maximum under the executive programs. The plans themselves function quite differently, with the executive incentive payouts being determined fully by performance vs. financial goals and the Senior Management Incentive Plan measuring performance vs. the three goals described above.

Observations and Recommendations

The two incentive plans employ market typical designs in a number of ways. We offer the following observations and recommendations for consideration:

- Eligibility: It is a typical market practice to have all non-represented employees eligible to participate in an annual incentive program. The percentage of these employees covered by variable pay has been increasing over time. MDU and GPNG bargained employees participate in these plans. We recommend no change in eligibility for either plan.
- Metric selection: MDU and GPNG has created a balanced scorecard of financial performance, cost management, and customer service. This is often reflected in the market place and the inclusion of customer service is a design feature that we strongly encourage, particularly for utility companies. Given the regulatory environment, we often see commissions focused on ensuring affordable delivery of utilities, while managing an acceptable standard of customer service. MDU and GPNG plans include a significant and appropriate portion of incentive compensation focused on customer service and cost management. This is balanced with ensuring affordability of the plan but focusing a portion of the award on financial achievement. Furthermore, the significant impact on payout for failing to achieve a threshold level of performance for any one of the metrics enhances the weight and importance of each goal (i.e., failure to achieve any one goal substantially impacts the payout of the entire award).
- Leverage curve: The leverage curves for both incentive plans fall within standard market practice. While it is most common to have a maximum payout opportunity of 200%, 150% is also commonly seen, particularly for programs that apply to a broad group of employees. We do question the need for different leverage curves between the two employee groups, particularly since the goals are the same and the programs work identically (other than the leverage curve). Essentially, a participant in the Senior Management Incentive Plan can receive a larger payout than a participant in the Employee Incentive Plan for the exact same level of performance, in the event that the Company exceeds its financial target goal. However, should financial performance fall below expectations, both participants will receive an equivalently reduced payout percentage. Optically, this could be problematic. We understand that the current design of the Senior Management Incentive Plan was intended to mirror the executive plans discussed above and believe this rationale to be sound. We suggest considering modifying the leverage curve in the Employee Incentive Plan so that the maximum under the plan is also 200%. This would eliminate a perceived inequity between senior management and the rest of the employee population.

We reviewed the historical payouts under the incentive plans for the years 2010 through 2012. On average, the overall payouts for MDU and GPNG were 97% of target. Typically over a 10-year time frame, we would expect to see payouts averaging around 100% of target. This would support agreement that goal setting is sound and effective and that the goals that are being set are sufficiently challenging, but also are achievable.

The following table shows the approximate historical financial achievement for each business unit:

Year	MDU/GPNG
2010	Exceeded
2011	Target
2012	Below Target

Payouts below target are exacerbated because payout for any portion of the award can drop to zero if a goal is missed (Operations and Maintenance and Customer Service Goals) and there is no opportunity to receive above target levels for two out of three of the metrics. This will inherently drive payouts lower overall. This can be modified either by incorporating above target payouts for the Operations and Maintenance and Customer Service goals or be increasing the leverage on the Financial Goal.

In addition to the program design review, we reviewed the target incentive compensation levels and total cash (base + incentive compensation) positioning. As a result of this review, we find that, in general, the plans appear to be strong and the targets are set within market norms. Please note that MDU and GPNG's incentive targets are not round numbers (e.g., 4.5%, 6.5%, etc.). While this degree of precision in target setting is unusual (we typically see the use of round numbers), we understand that targets were set so that MDU and GPNG could integrate all business units into one incentive plan on a cost-neutral basis. Given this perspective, we support this practice.

We suggest reviewing target award opportunities offered through the Senior Management Plan with those in the executive plans to ensure that it is appropriate for employees placed in grade 41 to receive the same target incentive opportunity as those placed in grade B (similarly, compare grade 42 and grade C).

Competitive Positioning

Aon Hewitt performed market pricing for 122 jobs at MDU and GPNG. These jobs represent 72% of the non-union, non-executive employee population. This is an excellent coverage percentage. We used Mercer and Towers Watson general industry surveys, along with energy services survey provided by MDU and GPNG to obtain market data. All data was aged to September 1, 2013 using an annual adjustment factor of 3%. For non-utility specific roles, we used national general industry market data. We believe this is the appropriate cut of data given that these roles could be performed by any individual with relevant experience, regardless of industry. As discussed previously, many MDU and GPNG employees are located in areas where the cost of labor is about 10% below the national average. We suggest keeping this fact in consideration when reviewing results, particularly for the jobs at lower grade levels in the organization for which MDU and GPNG will recruit locally.

AON Hewitt

For all jobs in the aggregate (across all grades), MDU and GPNG base salary levels and total cash compensation are within the market competitive range ***(91% and 92% of market for base salary and total cash, respectively)***, but nearing below-market levels. This calculation is performed on an "incumbent weighted basis". If the calculation was performed on a "job weighted basis", the competitive positioning would be 94% of market. The difference is primarily due to a single position, namely the Customer Service Representative in Salary Grade 30. There are 92 incumbents in this role and their average compa-ratio is .79. The 91% incumbent based value counts the Customer Service Representative compa-ratio 92 times. The 94% job weighted value counts the Customer Service Representative compa-ratio once.

Note: Aon Hewitt defines market competitive to be plus or minus 10% of market.[1]

The following is a summary of market positioning by salary grade:

	Avg. EE Pay			Avg. Mkt Pay			MDU/Market		Midpoint/Market
Grade	Base	Actual TCC	Target Bonus %	Base	Actual TCC	Target Bonus %	Base	Actual TCC	
29	27,394	28,609	4.5%	32,688	32,900		0.84	0.87	0.76
30	26,360	27,051	4.5%	33,350	33,550	5.7%	0.79	0.81	0.85
31	32,232	33,596	4.5%	34,465	35,005	4.8%	0.94	0.96	0.94
32	36,338	37,879	4.5%	39,069	39,614	6.6%	0.93	0.96	0.97
33	42,999	44,770	4.5%	49,843	51,369	5.9%	0.86	0.87	0.89
34	50,574	52,842	6.5%	56,430	58,165	6.5%	0.90	0.91	0.91
35	56,404	58,853	6.5%	61,582	63,766	7.2%	0.92	0.92	0.97
36	67,858	71,573	6.5%	73,673	76,770	8.3%	0.92	0.93	0.94
37	77,761	82,003	6.5%	88,062	93,680	9.7%	0.88	0.88	0.91
38	92,554	99,925	9.5%	95,876	102,126	11.8%	0.97	0.98	0.96
39	103,174	112,435	9.5%	105,978	115,531	13.3%	0.97	0.97	0.98
40	116,291	126,733	9.5%	112,829	122,327	14.5%	1.03	1.04	1.04
41	133,448	146,012	15.0%	137,820	155,200	21.4%	0.97	0.94	0.95
42	148,093	167,321	20.0%	144,550	166,963	22.9%	1.02	1.00	1.02
Incumbent-weighted Avg:	55,922	58,976		61,565	64,355		0.91	0.92	0.93
Job-weighted Avg:	70,467	75,247		75,212	79,982		0.94	0.94	0.95

*Market base and Actual TCC data is based on Mercer Towers Watson, and other utility-specific data sources as described above. Target bonus percent data is not available from all of these survey sources. Target bonus percent data is based primarily on Towers Watson survey data.

In general, pay positioning slightly improves as one moves further up in the grades. Overall, we consider pay at MDU and GPNG to be within market competitive levels.

[1] The measurement and assessment of the external market follows a structured and consistent process, however, it is not an exacting science. The market is dynamic and there are inevitable differences in peer groupings across surveys and within surveys across time. Additionally, inasmuch as every organization is unique, the establishment of exact job matches is not possible. Compensation theory states that a 75% overlap of duties and responsibilities represents "a match." Lastly, differences in incumbent pay due to performance, experience, and scope factors also add dispersion to the data. For these reasons we define "market competitive" from a salary perspective to be plus or minus 10% of market.

We have also reviewed the comparison of the grade midpoints of MDU and GPNG's salary structure compared to the market pricing results for MDU and GPNG jobs. The average positioning of midpoints versus market data for all jobs is 0.95. This suggests that the majority of jobs are currently well-placed in grading structure and that MDU and GPNG's salary structure is in line with the market.

The job families that deserve the greatest focus are the customer service representatives, engineers, and financial analysts. Most jobs in these families have salary to market ratios of under .9 and there are a number of incumbents impacted by this under-competitive pay. However, there are a number of single incumbents that have low salary to market ratios. While all incumbents with low salary to market ratios should be examined, we do not believe that this poses a significant issue unless the employees fall into a protected class.