

Before the North Dakota Public Service Commission  
State of North Dakota

In the Matter of the Application of Otter Tail Power Company  
For Authority to Increase Rates for Electric Utility  
Service in North Dakota

Case No. PU-17-398  
OAH File No. 20170622

Exhibit \_\_\_\_

**EMPLOYEE COMPENSATION**

Rebuttal Testimony and Schedule of

**Peter E. Wasberg**

**PUBLIC DOCUMENT – NOT PUBLIC (OR PRIVILEGED)  
DATA HAS BEEN EXCISED**

June 22, 2018

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Schedule 1 – OTP’s Response to ND-02-098 in Case No. PU-08-862 NOT PUBLIC

1 **I. INTRODUCTION**

2 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

3 A. My name is Peter E. Wasberg and my business address is Otter Tail Power Company,  
4 215 South Cascade Street, Fergus Falls, Minnesota.

5  
6 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

7 A. I am employed by Otter Tail Power Company (OTP or the Company) as Director, Human  
8 Resources and Safety, a role I have been in since 2008. I have worked in OTP's Human  
9 Resources Department continuously since 2004, and prior to that I served in various  
10 positions within the Customer Service area of OTP, starting in 1991.

11  
12 Q. DID YOU PREPARE DIRECT TESTIMONY IN THIS PROCEEDING?

13 A. Yes. On November 2, 2017, I filed Direct Testimony with the North Dakota Public  
14 Utility Commission (Commission) in this proceeding that detailed my background and  
15 qualifications and addressed matters related to employee compensation and benefits for  
16 OTP. That included describing OTP's current overall compensation program, notably its  
17 two annual incentive plans (collectively the OTP Annual Incentive Plan), and then  
18 discussed how the compensation levels provided by OTP compare to the general market.  
19 I also explained the general benefits provided by OTP through its approach to employee  
20 compensation, as well as summarizing OTP's 2018 Test Year compensation and benefits  
21 costs.

22  
23 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

24 A. The purpose of my testimony is to respond to certain recommendations in the Direct  
25 Testimony of Mr. Ralph C. Smith filed on behalf of the Commission's Advocacy Staff  
26 (Staff). Specifically, I respond to Mr. Smith's recommendations regarding the OTP  
27 Annual Incentive Plan and how those incentives are part of OTP's total compensation

1 approach. I also respond to Mr. Smith's proposal to eliminate or split several  
2 components of our total compensation. Finally, I address Mr. Smith's testimony and  
3 recommendations as to OTP's non-employee Director stock grants.  
4

5 Q. DOES YOUR REBUTTAL TESTIMONY DRAW UPON THE REBUTTAL  
6 TESTIMONY OF OTHER OTP WITNESSES?

7 A. Yes. I relied upon and incorporated the Rebuttal Testimony recommendations of other  
8 OTP witnesses, and identify those witnesses in my discussion at appropriate junctures.  
9 Of note, and to avoid confusion, Company Witness Tyler Akerman's Direct and Rebuttal  
10 Testimony explain and support the incentive plan specific financial amounts and  
11 calculations as accrued for and adjusted for the Test Year, as well as addressing the  
12 specific payroll tax impacts of various incentive compensation related adjustments,  
13 whereas my Rebuttal Testimony focuses on describing the need and benefits of having an  
14 incentive compensation as part of a competitive total compensation approach, OTP's  
15 labor costs, and non-employee Director compensation.

16 **II. SUMMARY OF REBUTTAL TESTIMONY**

17 Q. MR. WASBERG, PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

18 A. In responding to Mr. Smith's testimony and recommendations regarding compensation  
19 issues, my Rebuttal Testimony makes the following key points:

- 20 ● My Rebuttal Testimony provides the Commission with a more comprehensive  
21 understanding of OTP's compensation programs and the well-reasoned approach  
22 that underlies our compensation decisions and how those decisions benefit  
23 customers. OTP's Annual Incentive Plan reflects our philosophy that having a  
24 portion of employee pay "at risk" creates a desire within employees, including  
25 management, to each and every year seek continuous improvement in their work,  
26 and to focus on specific goals and areas within their roles such as controlling  
27 costs, providing outstanding reliability and customer service, and employee  
28 development.

1           •     Mr. Smith is incorrect in asserting that these costs, or any component of them, are  
2                     uniquely or primarily intended to only benefit shareholders or that they provide  
3                     benefits only to shareholders. To the contrary, customer and shareholder benefits  
4                     directly correlate. The apparent view of Mr. Smith that shareholders and  
5                     customers are somehow mutually exclusive constituents, where financial  
6                     performance benefits shareholders but not customers, ignores the fact that OTP's  
7                     implementation of these goals has provided direct and measurable benefits to our  
8                     customers by providing very high-quality service at the lowest cost of any  
9                     investor owned utility in North Dakota, as OTP witness Mr. Bruce Gerhardson  
10                    has explained. That performance proves that what underlies a utility's financial  
11                    success is also very important to customers. This point can be seen in OTP's  
12                    success in the alignment of effective management and control of costs with goals  
13                    of maintaining and improving the quality and reliability of service while also  
14                    maintaining very low rates for our North Dakota customers.

15                    In short, Mr. Smith's proposals to disallow recovery of substantial components of  
16                    total compensation are inappropriate, arbitrary and based on unsound assumptions  
17                    that there is an inherent conflict between the goals of shareholders and customers'  
18                    interests. OTP's performance disproves those assumptions. The Commission  
19                    should make an assessment of the overall compensation and benefit package that  
20                    is offered by OTP, and if it is reasonable, it should be approved. There should be  
21                    no disallowance as Mr. Smith advocates for, divorced from an assessment of the  
22                    overall compensation costs of these employees.

23           •     OTP's compensation costs are reasonable, market-based and necessary to attract  
24                     and retain the workforce needed to provide our utility service, and to motivate  
25                     employees, including management and executives, to be efficient, cost-conscious  
26                     and to reach beyond adequate utility service to achieve operational excellence.  
27                     Mr. Smith's recommendations would not allow OTP to recover the necessary and  
28                     prudent costs of providing service in North Dakota.

- 1           ●     Putting pay “at risk” is a crucial tool is helping OTP reach – and hopefully exceed  
2                     – its goals in areas such as safety, fostering a compliance culture, process  
3                     improvement, cost control, protecting key assets, customer service, management  
4                     of capital projects (both large and small), and well-performing generation units. It  
5                     should be obvious that it is not in customers’ interests to have a utility operating  
6                     around total compensation paid without regard to employee performance.
- 7           ●     The combination of base pay, annual incentives and long-term incentives enables  
8                     OTP to reward employee performance – including management – in encouraging  
9                     continuous improvement through the use of the most appropriate pay components  
10                    for individual positions. This combination, at the heart of our overall  
11                    compensation strategy, creates a strong link between pay and performance at the  
12                    individual, team, company and corporate levels. It helps ensure employee  
13                    commitment by recognizing and rewarding contributions to the Company’s  
14                    operational and financial success, while reinforcing our vision, Mission and  
15                    initiatives as well as our core values of safety, customer focus, resourcefulness,  
16                    integrity and community.
- 17          ●     With regard specifically to management, our experience demonstrates that  
18                    incentives such as restricted stock serves as a strong retention tool, ensuring the  
19                    stability of our management and other key contributors. The management  
20                    incentives and the OTP Annual Incentive Plan, in particular, are designed to focus  
21                    management on the development and implementation of long-term strategic  
22                    objectives and initiatives, to make prudent long-term decisions, and to effectively  
23                    manage and control OTP’s costs of providing safe and reliable electric service to  
24                    our customers.
- 25          ●     Taken together, the Company’s base salaries and variable targets constitute a  
26                    reasonable level of costs prudently incurred as consistent with market conditions  
27                    and should be reflected in OTP’s rates.

1 **III. RESPONSE TO MR. SMITH'S RECOMMENDATIONS**

2 Q. PLEASE SUMMARIZE MR. SMITH RECOMMENDATIONS REGARDING  
3 INCENTIVE AND STOCK-BASED COMPENSATION COSTS.

4 A. Mr. Smith makes several recommendations regarding recovery of the Company's  
5 incentive compensation and stock-based compensation costs in this proceeding:

6 1. The OTP Management Plan. Mr. Smith recommends "that 50% of the incentive  
7 compensation related to the OTP Management Plan that is included in the 2018  
8 test year be borne by shareholders." (Smith Direct, p. 37).

9 2. The Otter Tail Corporation (OTC) Executive Annual Plan. Mr. Smith  
10 recommends that "90% of the incentive compensation related to the OTC  
11 Executive Annual Plan that is allocated to OTP and included in the 2018 test year  
12 be borne by shareholders." (Smith Direct, pp. 39-40)

13 3. Executive Survivor and Supplemental Retirement Plan (ESSRP). Mr. Smith  
14 recommends removing "100% of the expense for OTP's ESSRP from the 2018  
15 test year cost of service." (Smith Direct, p. 52).

16 4. Employee Stock-based compensation expenses. Mr. Smith recommends  
17 disallowing all such 2018 test year cost of service stock-based compensation  
18 expense. (Smith at 41:15-17).

19 5. Non-Employee Board of Director Stock Grants. And, while a necessary and  
20 required expense that is not "incentive compensation," Mr. Smith similarly  
21 recommends that the cost of the non-employee Board of Director restricted stock  
22 grants also be removed from 2018 Test Year cost of service. (Smith Direct, p. 47-  
23 48, with an allocated-based recommendation for reducing 2018 Test Year cost of  
24 service by \$118,091 on a North Dakota jurisdictional basis).

25

26 Q. WHAT IS THE PRIMARY BASIS FOR THESE RECOMMENDATIONS?

27 A. In general, the overall levels or reasonableness of costs being incurred by OTP is not  
28 being challenged. Rather, Mr. Smith instead has focused on *manner* of compensation.  
29 Generally speaking, it is my understanding that Mr. Smith has made these

1 recommendations based on his idea that incentive compensation tied to a utility's  
2 financial performance should not be borne by ratepayers (Smith Direct, p. 40). Mr.  
3 Smith's recommendations also reflect his belief that there is an inherent and severe  
4 conflict between the interests of utility shareholders and utility customers.  
5

6 Q. WHAT IS YOUR OVERALL RESPONSE TO MR. SMITH'S BASIS FOR THESE  
7 RECOMMENDATIONS

8 A. I have two overall responses. First, this view ignores the collective benefits of placing a  
9 portion of overall total compensation "at risk," and the other values and goals that are  
10 promoted by these incentives such as safety and compliance. I address the non-financial  
11 performance-based components in the OTP Annual Incentive Plan at length later in my  
12 Rebuttal Testimony.

13 Second, Mr. Smith is incorrect that there is an inherent conflict between  
14 shareholder and customer interests. That view of Mr. Smith's ignores the fact that, a  
15 financially healthy and cost-conscious utility is a good thing for North Dakota customers,  
16 as OTP's record of high quality service and low rates demonstrates. Customers certainly  
17 benefit from optimized employee performance; they also benefit from a stable and  
18 financially healthy utility. Promotion of these goals is good regulatory policy. It is  
19 prudent, commonly-employed in the industry and with good reason: it helps in directly  
20 promoting a strong utility with positive customer benefits. Our pay levels overall are  
21 competitive at a modest, median-comparable level, and necessary to providing the quality  
22 employees we need in today's labor market so that we can continue to deliver high  
23 quality service at low rates.  
24

25 Q. PLEASE SUMMARIZE MR. SMITH'S RECOMMEND ADJUSTMENTS TO  
26 ANNUAL INCENTIVE COMPENSATION FOR EXECUTIVES AND KEY  
27 MANAGEMENT PERSONNEL?

28 A. As I noted above, Mr. Smith recommends: (1) A 50 percent reduction of the incentive  
29 compensation related to OTP Management Plan that is included in the 2018 test year; (2)  
30 a 90 percent of the incentive compensation related to the OTC Executive Annual Plan

1 that is allocated to OTP and included in the 2018 test year; (3) elimination of 100 percent  
2 of all identified stock-based compensation directly charged to OTP; and (4) elimination  
3 of 100 percent of the expense for ESSRP included in the Company's 2018 Test Year.

4 **A. OTP Management and OTC Executive Annual Incentive Compensation**

5 Q. BEFORE WE ADDRESS THE MERITS OF MR. SMITH'S OPINIONS, WERE THE  
6 NUMBERS UTILIZED BY MR. SMITH CORRECT WITHIN HIS  
7 RECOMMENDATION FOR THE OTP MANAGEMENT AND OTC EXECUTIVE  
8 INCENTIVE COMPENSATION IN THE 2018 TEST YEAR?

9 A. No. OTP provided Mr. Smith with an incorrect number in our response to ND-PSC-  
10 15.19 that he used for his calculation. Our answer to "a." was the total amount of the  
11 Otter Tail Corporation incentive attributable to OTP and the number did not get reduced  
12 for any amounts over 25%, which we did remove in our request. The corrected number in  
13 Mr. Smith's RCS-1 Schedule C-5, Line 7, should be \$497,913, which is \$834,429, less  
14 \$336,516, representing any individual amounts that exceeded 25%. Using the correct  
15 number would change Mr. Smith's Line 12 "Total Recommended Adjustment to  
16 Incentive Compensation Expense" to \$315,116, or a reduction of \$122,589, were the  
17 Commission to consider Mr. Smith's total adjustment number within the context of his  
18 recommendations on incentive compensation.

19  
20 Q. DO YOU HAVE AN OVERALL REACTION TO THE INCENTIVE COMPENSTION-  
21 RELATED RECOMMENDATIONS BY MR. SMITH?

22 A. Yes. I think Mr. Smith has assumed a division of interests where none really exists.  
23 Shareholder and customer interests are aligned under the Company's approach. I do not  
24 accept the premise that the benefits from OTP's approach to incentive and total  
25 compensation accrue in a manner to shareholders such that they should be disallowed in  
26 North Dakota cost of service. Rather, the record shows that customers have received  
27 very high-quality service at very low rates during the time when our incentive plans have  
28 been in effect.

1           Our Company’s incentive-based compensation is first and foremost one of the  
2 core, basic components of the total compensation provided to employees, without which  
3 we would not have a competitive pay package. By “competitive” I mean in the sense that  
4 the compensation we offer must provide the same general pay levels and components in  
5 its total remuneration package as are included in the packages provided by our  
6 competitors for labor. My testimony is intended to provide the Commission with a more  
7 comprehensive understanding of the well-reasoned business decisions that underlie  
8 OTP’s compensation approach. At its core our compensation approach is designed to  
9 optimize employee performance and, in turn, improve service to customers by reinforcing  
10 our core values of service, safety, and focus on the customers and communities we serve.  
11

12 Q.   HAVE THE OTP INCENTIVE PLANS RESULTED IN EXCESSIVE LEVELS OF  
13 COMPENSATION?

14 A.   No, they have not. As I explained in my Direct Testimony, OTP carefully bases its total  
15 compensation on the market. As one of the key people at OTP following that market, I  
16 can say that virtually every investor-owned utility uses variable short- and long-term  
17 compensation – putting some pay “at risk” – as part of their total compensation structure.  
18 At least since I began working in this area, I have seen incentive compensation  
19 increasingly becoming standard at publicly traded companies, with “pay for  
20 performance” now typical in the compensation field. In my experience, a utility must  
21 follow that approach to remain competitive in attracting and retaining talented  
22 employees. It is also my experience that incentive-based compensation serves as a  
23 critical instrument in motivating employees – including management – to meet and  
24 exceed high standards of operating excellence, thereby creating efficiencies, and  
25 improving performance in many areas such as safety, and cost control – all of which  
26 clearly benefits our customers. Accordingly, a well-designed compensation program, the  
27 type that can best benefit customers, is one that includes not only base salary and  
28 appropriate merits adjustments but one that also provides opportunities that can reward  
29 the achievement of short-term and long-term goals. That paradigm is also consistent with

1 the Commission's approach to regulation in North Dakota, which encourages efficient  
2 utility operations and promoting long-term stability for those utilities.

3  
4 Q. WHY IS PUTTING PAY AT RISK SUCH AN IMPORTANT PART OF OTP'S  
5 COMPENSATION PLAN?

6 A. Putting pay "at risk" is a crucial tool is helping OTP reach – and hopefully exceed – its  
7 goals in areas such as safety, process improvement, cost control, customer service,  
8 management of capital projects (both large and small), and well-performing generation  
9 units. It should be obvious that it is not in customers' interests to have a utility operating  
10 around total compensation paid without regard to employee performance. I believe that,  
11 on the whole, people perform better when there are clear goals and a monetary reward for  
12 meeting these goals, and a monetary penalty for failing to meet those goals. Employees  
13 are most engaged when they have a clear understanding of what is expected, and when  
14 they are getting feedback on how they are performing against those expectations.  
15 Incentive compensation is not a "bonus" – it is at risk compensation with an upside  
16 opportunity for our employees to earn above base pay for solid performance, but also  
17 with the trade-off of falling below the target pay if goals are not met, with some room in  
18 between to address individual and team performance. I will further explain the  
19 importance of this concept later in my Rebuttal Testimony when I discuss OTP's "Total  
20 Compensation" approach.

21  
22 Q. HOW DO THOSE RECOMMENDED ADJUSTMENTS ALIGN WITH THE MERCER  
23 SURVEY DATA?

24 A. They don't. Mr. Smith is recommending reductions that would not allow us to recover  
25 the costs of total compensation competitiveness in the market for executive and key  
26 management compensation. As I will explain later and have also explained in my Direct  
27 Testimony, OTP executive compensation is actually below market, and we saw data for  
28 other employees at OTP that showed similar results. As I said at the outset, Mr. Smith  
29 did not recommend any reductions to total compensation for other employees and we  
30 don't believe executive and key management compensation should be treated differently.

1 Q. DOES MR. SMITH PROVIDE A REASON FOR HIS RECOMMENTATIONS?  
2 A. Yes. Mr. Smith notes that these are costs that “should be borne by shareholders” and that  
3 “Ratepayers should not be required to pay executive or management compensation that is  
4 based on the performance of the Company’s (or its parent company’s) stock price, or that  
5 has the primary purpose of benefitting the parent company’s shareholders and aligning  
6 the interests of participants with those of such shareholders.”  
7

8 Q. DO YOU AGREE WITH MR. SMITH’S REASONING?

9 A. No, I do not. The proposals to split, or disallow, incentive compensation costs to  
10 management presumes that shareholders are benefitting at the expense of customers, and  
11 this simply is not true. Obviously, managing our utility operations efficiently can have  
12 financial benefits to both customers and shareholders if it reduces our operating costs,  
13 which of course are funded by our customers. In addition, as raised more generally by  
14 Company witness Kevin Moug, strong financial performance also benefits customers by  
15 giving OTP the ability to attract capital on more reasonable terms, allowing necessary  
16 investment in infrastructure to serve customers such as the planning related to resource  
17 retirements. An organization that is not financially successful will incur higher costs in  
18 making longer term infrastructure investments such as those made at Big Stone Plant,  
19 which would have a direct adverse impact on customers. We believe a more logical  
20 conclusion would be that the Company should be encouraged to compete well for the best  
21 talent and to create and maintain an environment that encourages employees to do their  
22 best, exceeding expectations to the benefit of investors, themselves and our customers.

23 The Company’s incentive compensation plans, which are based on a combination  
24 of company, responsibility- and team-specific and individual performance objectives, are  
25 reasonably designed to encourage optimal performance by management (similar to all  
26 employees but placing even more at risk) in many areas important to customers,  
27 including many which provide a direct benefit to OTP’s customers. The fact that these  
28 goals align with overall company performance objectives should not form the basis to  
29 exclude a portion of the incentive compensation costs as long as the total compensation  
30 approach is reasonable.

1 Q. HOW DOES MR. SMITH'S RECOMMENDATION ALIGN WITH OTP'S NEED TO  
2 RECRUIT AND RETAIN KEY EMPLOYEES?

3 A. His recommendation does not align with OTP's need to compete with other employers in  
4 the utility and other industries (including our suppliers), and that our management  
5 incentive plans and total compensation approach affects both our ability to recruit and  
6 hire new employees, as well as retain our best employees who have opportunities to work  
7 elsewhere. We have designed our compensation programs to be appropriately in line and  
8 competitive with the industry. I have seen firsthand that talented employees are  
9 sophisticated enough to understand total compensation, and they are looking for  
10 competitive pay and benefits, upside opportunity on performance, and in the case of  
11 qualifying participants, the opportunity to receive long-term stock ownership.

12 The OTP Annual Incentive Plan helps us retain our experienced and talented  
13 management team. And in particular, that management incentive compensation is  
14 designed to have a higher portion of their total compensation at risk and can be forfeited  
15 and can include certain claw back provisions if qualifying participants leave the  
16 Company before the end of the performance period or vesting dates. This is another  
17 component providing incentives for retention of high performers and a tool to encourage  
18 prudent long-term decisions and the successful implementation and execution of long-  
19 term strategies designed to help OTP meet the future needs of our customers.

20

21 Q. MR. SMITH REFERS TO STATEMENT OF FINANCIAL ACCOUNTING  
22 STANDARD (SFAS) 123 AS A REASON STOCK-BASED COMPENSATION IS  
23 BEING PROPOSED FOR RECOVERY FROM RATEPAYERS (SMITH, p. 44). IS AN  
24 ACCOUNTING STANDARD THE REASON STOCK-BASED COMPENSATION IS  
25 INCLUDED IN THE COST OF SERVICE FOR OTP?

26 A. No. SFAS 123 was issued in October of 1995. OTP's first rate case in approximately 25  
27 years was filed in 2008, some 13 years after that accounting standard was issued. Stock-  
28 based compensation was included in that case as well.

1 Q. WHAT IS THE COMPENSATION ALTERNATIVE FOR OTP IF RECOVERY OF  
2 ANNUAL CASH INCENTIVE COMPENSATION IS NOT ALLOWED?

3 A. If our variable compensation components were excluded or reduced, OTP's  
4 compensation would no longer be competitive with the market. Adoption of Mr. Smith's  
5 recommendations would signal OTP must either compete for talent with an inferior  
6 compensation offering or that rates paid by its customers must be supplemented by non-  
7 service revenues to deliver competitive compensation levels. As noted in my Direct  
8 Testimony, without annual incentive compensation, the only way to maintain a  
9 competitive total compensation package would be to increase base salaries. Doing so  
10 would increase other costs, as base salaries for executives can tie to other benefits, such  
11 as 401(k) and pension. Reducing at risk pay, and increasing base pay also takes away  
12 how our well-designed incentives work. Having at risk pay is a benefit to our customers  
13 because executives and key management employees are only getting the additional total  
14 compensation when they are helping to achieve goals that are directly benefiting  
15 customers and shareholders. If we don't meet these goals, these employees are negatively  
16 impacted in their total compensation. We know these employees want to meet the goals,  
17 not only because it is good for our customers, but also because it is beneficial to their on-  
18 going success at OTP.

19 Again, the OTP Annual Incentive Plan requires the employee to re-earn the  
20 incentive reward every year, and if performance expectations are not met incentive pay is  
21 reduced or eliminated. Incentive pay, therefore, does not become a permanent fixed cost.  
22 Thus, by moving a portion of each employee's pay from base pay to incentive pay, the  
23 OTP Annual Incentive Plan reduces the Company's overall labor costs by avoiding the  
24 compounding effect of annual base pay increases. Similar to the superior employee  
25 performance, the cost savings occur regardless of whether the financial performance goal  
26 is met, and incentive compensation is paid.

27 We believe it is in the best interest of all key stakeholders, including customers  
28 and our workforce, to allow OTP to define its compensation programs to achieve key  
29 business objectives, versus an approach that arbitrarily pushes the design of a program  
30 not tied to at risk pay and performance goals. Put another way, to deny recovery of half

1 (fifty percent), or 90 percent, or in some cases 100 percent of incentive compensation, as  
2 Mr. Smith recommends at various points, is wholly arbitrary, excluding without basis a  
3 legitimate component of overall reasonable compensation and a component of which  
4 benefits customers by directly incentivizing performance goals. It is difficult for me to  
5 conceive that the preference on behalf of a utility – or regulators – would be to encourage  
6 nothing beyond baseline or minimal targets, as opposed to setting higher standards as our  
7 incentive compensation program does.

8

9 Q. DO YOU AGREE THAT BENEFITTING SHAREHOLDERS NEGATIVELY  
10 IMPACTS CUSTOMERS?

11 A. No. As our Mission states, we work “to the balanced benefit of customers, shareholders,  
12 and employees...”. Each group listed is critical to our ability to meet our Mission, and  
13 each group is dependent on the others’ success. If we put too much emphasis on one  
14 group, it would cause negative impacts on the other groups. The balance is important and  
15 having a strong shareholder group directly benefits our customers and employees. If we  
16 have engaged employees, good reliability, competitive rates and shareholders who are  
17 investing in our future, OTP will be successful, and each group will enjoy that success.  
18 Our incentives clearly *are* in our customers’ interest. We strive to reward employees and  
19 management for “line of sight” goals – aligning an employee’s job responsibilities and  
20 their day-to-day activities with OTP’s overall strategic objectives. Our incentive  
21 compensation program is an important tool that must be used in order for us to achieve  
22 the overall goal of effectively managing our human capital, which includes the right  
23 compensation strategy at all levels. Mr. Smith’s view that the primary purpose of  
24 management incentives is directed at the Company’s financial performance overlooks the  
25 existence of operational, customer-driven goals as part of our total compensation.

26 Mr. Smith’s mutually exclusive view of benefits and costs is inaccurate. There is,  
27 I believe, a symbiotic relationship between customers and shareholders. OTP exists for  
28 the benefit and in service of its customers. To the extent we excel in providing quality  
29 service at a reasonable price to customers, it becomes attractive to investors. Likewise, to  
30 the extent a given utility provides poor service to customers or does not manage its costs,

1 infrastructure and key projects, it becomes a very unattractive long-term investment. And  
2 customers certainly benefit from a well-run utility. If the utility operates efficiently, its  
3 cost of service will presumably be positively impacted, to the benefit of customers. It can  
4 forestall or eliminate the need for future rate relief, for instance.

5 Because variable compensation varies with business results, it encourages  
6 employees, including management, to focus on goals that are intended to drive  
7 efficiencies, maintain safety, improve processes and deliver financial results that ensure  
8 the ongoing viability of the service provider. Based on OTP's record of successfully  
9 implementing its total compensation approach, we have a valuable tool to promote and  
10 sustain excellent employee performance.

11  
12 Q. ARE OTP MANAGEMENT INCENTIVE OBJECTIVES TIED TO CUSTOMER  
13 BENEFITS?

14 A. Yes. The management incentives are not only tied to Company financial performance.  
15 Indeed, a host of other goals that also benefit customers and the safe and reliable  
16 operation of our system figure prominently in those incentive compensation decisions  
17 and weighting of management goals. As I stated in my Direct Testimony, the OTP  
18 Management Plan includes: (1) safety; (2) a number of individual criteria that vary by the  
19 employee's job and responsibilities; and (3) two overall financial criteria relating for OTP,  
20 with the safety and individual criteria weighted at 50 percent and the financial criteria  
21 weighted at 50 percent.

22  
23 Q. CAN YOU PROVIDE A SPECIFIC EXAMPLE.

24 A. Yes. Let's look at the Company's Management Incentive Plan (MIP) over the last  
25 several years, as it has been applied to the position of OTP's Vice President (VP) –  
26 Customer Service. That VP position has included many goals beyond financial  
27 performance, in a host of areas both impacting and directly dependent on various safety  
28 metrics. MIP incentives for that position have also included a direct tie to customer  
29 satisfaction, based on survey data including data specific to the Company. The VP-  
30 Customer Service MIP compensation has also been made dependent upon performance

1 goals that directly relate to reliability and restoration of service, most notably basing the  
2 incentive on Customer Average Interruption Duration Index (CAIDI) performance.  
3 CAIDI a reliability metric well-recognized in the utility industry and is a widely-utilized  
4 reliability index that gives the average outage duration that a given OTP customer might  
5 experience, *i.e.*, the average restoration time. Commensurate with the role and  
6 responsibilities of this Company VP, goals that impact customer satisfaction, the  
7 customer experience, service/storm restoration and the safety of workers such as those  
8 involved in such service restoration efforts are given high priority. That position also ties  
9 incentives to providing that service to our customers in an environmentally responsible  
10 manner, with incorporation of goals tied to incentives such as those for Demand Side  
11 Management successes.

12  
13 Q. ARE THERE OTHER EXAMPLES OF MIP INCENTIVE GOALS THAT HAVE  
14 PROVIDED DIRECT BENEFITS TO OTP'S CUSTOMERS?

15 A. Yes, there are. Another example that is illustrative as to how the MIP helps benefit  
16 customers can be seen in the how the MIP is tied to the OTP VP-Asset Management  
17 position. Again, as with all we do, a safe workplace and encouraging safe work practices  
18 is a front-and-center priority and this is no exception for the VP-Asset Management who  
19 oversees areas including our larger transmission projects. Safety, safe practices and  
20 safety metrics also play a role in the MIP-tied incentives, which are part of that oversight  
21 and management of OTP's assets that fall under the VP-Asset Management's  
22 responsibilities. Because major transmission projects help maintain and enhance the  
23 transmission and delivery of energy to North Dakota customers, the VP-Asset  
24 Management incentives are also tied to the successful execution of those projects (again,  
25 safety, as well as "on time and on budget" considerations). In terms of execution of  
26 major projects, project management success and coordination of project management  
27 with customer service are further incentive through the MIP. Of particular note in recent  
28 years has been our focus on the successful execution for the Big Stone South (S.D.) –  
29 Ellendale (N.D.) (BSSE) and Big Stone South – Brookings (BSSB) transmission projects.  
30 BSSE and BSSB are important major projects that are and will be improving the

1 reliability of the regional electrical system, increase system capacity to address growth in  
2 regional demand and enable renewable energy to be better integrated into that system,  
3 while boosting regional economies by creating construction jobs and supporting local  
4 businesses. Due to the expenditures and timing of these projects, successful execution  
5 directly translates to benefits for our customers.

6 Also, for the VP–Asset Management position, the Company’s successful and  
7 cost-effective participation in the Midcontinent Independent System Operator (MISO) are  
8 tied to incentive compensation, including a range of goals such as expanding needed  
9 transmission capabilities, reliable coordination of transmission in the MISO market, and  
10 addressing matters related to our electric utility and cooperative neighbors such as the  
11 equitable handling of transmission contract expirations. That VP–Asset Management  
12 position has further incentives tied to process improvement and talent development.  
13 Because of the critical infrastructure and reliability importance integral to the Company’s  
14 cyber assets, that VP position’s MIP at risk compensation is also linked to there being no  
15 “cyber breaches.” Over the longer-term, the VP–Asset Management incentives are tied  
16 to Midwest Reliability Organization (MRO) compliance (*e.g.*, the Company’s  
17 performance related to reliability standards) and transmission strategies for dealing with  
18 Regional Transmission Organization “seams” (*e.g.*, generation interconnection planning  
19 and coordination, market coordination and deliverability, cost allocation and pricing,  
20 affected systems issues, delays *etc.*). It is hard to dispute that success by OTP on these  
21 many issues related to management of its critical assets – MISO-related, cyber, and  
22 transmission in particular – does not have impacts and, where successful, bona fide  
23 benefits to customers.

24 And while we all support and coordinate toward meeting these types of goals for  
25 the Company, the MIP directly aligns these goals (and their related benefits) with a  
26 clearly stated responsibility squarely placed on the management personnel with the most  
27 responsibility for seeing them through to success. That’s in contrast to a base-pay model,  
28 where performance is relegated to but a factor in any discretionary room in annual raises.  
29 With OTP’s approach, by tying such goals more directly to people and specific outcomes  
30 then linked to compensation, the incentives and accountability are clear.

1 Q. DO YOU HAVE ONE MORE EXAMPLE OF ALIGNMENT OF MANAGEMENT  
2 INCENTIVES WITH CUSTOMER BENEFITS?

3 A. Yes. A third example is the OTP MIP incentives associated with the VP–Planning &  
4 Strategy position, which has since 2017 morphed into or realigned with other roles on the  
5 Company’s Executive Team. That position’s incentives were tied to, of course, safety, as  
6 well as diligent management of the Company’s environmental services and avoidance of  
7 environmental notices of violation. That VP–Planning & Strategy position also had MIP  
8 incentives directly tied to the Company’s successfully implementation of its obligations  
9 under the Cross-State Air Pollution Rule (CSAPR) and navigating through impacts to the  
10 Company and its customers in addressing various federal and state environmental  
11 regulations and regulatory changes. While today overseen by the VP–Energy Supply  
12 position, resource planning was also formerly under VP–Planning & Strategy, and goals  
13 included identifying new generation opportunities and addressing how to best meet  
14 renewable standards. Energy supply-related incentivized goals have also routinely  
15 included protecting our baseload investments, including the lignite coal-fueled generation  
16 at Coyote Station in Beulah, North Dakota.

17 I could go on with other examples, but the three above clearly demonstrate that  
18 the management incentives are not limited to financial performance and include other  
19 areas that also benefit our customers beyond the “bottom line.” All participants in the  
20 MIP are incentivized and made to meet, on an annual (continuous) basis, varied goals tied  
21 to our customer service obligations, supporting key OTP initiatives, talent development  
22 and in seeking “continuous improvement” as part of those yearly total compensation  
23 decisions. Costs associated with variable pay can be, and in OTP’s case, are, aligned with  
24 performance and with the MIP management must “re-earn” the reward every year. If the  
25 sought level performance is not maintained or an employee leaves, variable pay can be  
26 reduced or eliminated, and there is a reduction in total compensation expense.

27 As noted throughout my testimony, safety is a core value at OTP. Our value  
28 states, “We provide safe workplaces and require safe work practices.” We know that safe  
29 workplaces are a requirement of all companies, but not all companies have the same  
30 results. Our long-term goal for the safety of our employees is to ultimately get to zero

1 accidents. Over time, we have been moving toward that challenging goal, and in 2017  
2 we had our best year to date, from an OSHA recordable standpoint. In 2018, through  
3 May, we are on track to better our 2017 results. We know that this is good for our  
4 employees, and we know that this is also good for our customers and shareholders. Our  
5 customers and shareholders benefit with lower incident rates because they aren't having  
6 to pay for injuries requiring medical, lost time, and worker's compensation costs. We  
7 know safety isn't about the OSHA numbers or the financial numbers, because those  
8 numbers represent co-workers who had an on-the-job injury. However, it provides  
9 another example of how our goals and incentives are aligned in a manner that directly  
10 benefits our customers, shareholders and employees through operational excellence.

11 These goals and having them tied to incentive objectives are designed to focus  
12 management on the development and implementation of long-term strategic objectives, to  
13 make prudent long-term investment decisions, and to effectively manage and control  
14 costs.

15 Our variable pay targets a portion of compensation dollars to key management  
16 employees and ensures top performers can be rewarded for their performance.  
17 Executives know exactly what is expected of them and know this performance will be  
18 rewarded; they also know some of their pay is at risk when the performance does not  
19 meet targets on key company measures. As part of this performance-based culture –  
20 reinforced through variable pay “at risk” – the organization can send signals about what  
21 is important, providing alignment and motivating commitment to our overall Mission and  
22 values. Key priorities can be identified, optimized and clearly understood. Through  
23 continuous measurement of results, high quality feedback can also be provided.  
24

25 Q. IS COMPANY FINANCIAL PERFORMANCE ALSO A PRIMARY FOCUS FOR  
26 MANAGEMENT?

27 A. It is certainly a goal, along with reinforcing other values and individual priorities for  
28 management such as those I just discussed for some of our VP positions. But again,  
29 controlling costs are in the customers' direct interests, as OTP's record of consistently  
30 low rates shows. Shareholders are not the sole beneficiaries of financial performance

1 improvements. To the extent that OTP management can minimize costs, improve  
2 processes and maximize productivity, shareholders and customers alike share in those  
3 benefits.

4  
5 Q. IS FINANCIAL PERFORMANCE ALSO TIED TO PERFORMANCE OF  
6 TRANSMISSION, DISTRIBUTION, AND GENERATION ASSETS?

7 A. Yes. The reliability and performance of our transmission & distribution system, and  
8 more directly as to our generating units, is also tied to that financial performance. As is  
9 reducing outage times, both in terms of costs and reliability of service. Getting more  
10 specific, financial performance and customer benefits are aligned in terms of completing  
11 projects and project milestones on schedule and on budget and developing and improving  
12 reliability solutions similarly creates real customer benefits, to name but a few examples  
13 of the goals encouraged by our incentive compensation plan's design create real customer  
14 benefits. For OTP to employ the talent necessary to meet its public service obligations  
15 and to motivate the employee performance necessary to meet targeted organizational  
16 performance objectives, we must be prepared to provide market competitive total cash  
17 compensation. That also enables the Company to motivate and retain executive  
18 leadership and other key management so that organizational performance objectives can  
19 be achieved.

20  
21 Q. IS THERE A STRONG CONNECTION BETWEEN EXECUTIVES AND PUBLIC  
22 SERVICE COMMITMENT?

23 A. Yes. The Company's Executive Team in particular "leads the charge" with respect to the  
24 Company's public service commitment, and not just in the areas of our low rates and  
25 customer-focused customer service. They are active members of the communities we  
26 serve, and in touch with the economic realities our customers face. That Executive Team  
27 also has demonstrated accomplishments in managing rates and successfully executing  
28 cost-effective beneficial projects, in effective resource planning and in promoting other  
29 core OTP values in their active promotion of economic development in our region,  
30 electrical safety, and in their community/civic involvement.

1           **B.    OTP's Executive Survivor & Supplemental Retirement Plan**

2    Q.    WHAT IS MR. SMITH'S RECOMMENDATION AND YOUR RESPONSE AS TO  
3    THE ESSRP?

4    A.    Mr. Smith recommends removing "100% of the expense for OTP's ESSRP from the 2018  
5    test year cost of service." (Smith page 52). As I explain below, there has been no  
6    underlying change in OTP's executive survivor & supplemental retirement plan (ESSRP)  
7    costs – these are the same costs that accrued prior to our last rate case and have been  
8    included in rates since that time. These are also reasonable expenses and the ESSRP has  
9    played an important role in the recruitment and retention of certain key employees.

10

11   Q.    PLEASE DESCRIBE OTP'S ESSRP.

12   A.    OTP's ESSRP was a defined benefit plan that was adopted to provide key executives and  
13   management employees competitive survivor and retirement benefits.

14

15   Q.    WHY DID OTP ADOPT THE ESSRP?

16   A.    In the early 1980s, certain tax law limitations reduced the amount of pension-related  
17   retirement benefits that could be received by key executives and management employees.  
18   The ESSRP was designed as a Supplemental Executive Retirement Plan and was  
19   transitioned to just a restoration benefit used to restore the pension-related retirement  
20   benefits of impacted employees to the baseline level of the overall Company pension  
21   plan.

22

23   Q.    DO OTHER UTILITIES UTILIZE A SERP OR ESSRP?

24   A.    Yes. According to information provided by Willis Towers Watson, an independent firm  
25   providing data related to compensation and benefits, 12 of 17 peer utilities have an open  
26   nonqualified Defined Contribution and five of 17 have an open nonqualified Defined  
27   Benefit. They also have noted that new nonqualified plans are generally restoration plans  
28   and that benefits are comparable to utility peers, with executive benefits benchmark near  
29   median.

- 1 Q. WHEN DID OTP ADOPT THE ESSRP?
- 2 A. The ESSRP was adopted in 1983.
- 3
- 4 Q. ARE NEW PARTICIPANTS BEING ADDED TO THE ESSRP?
- 5 A. No. The last participant was added 1/1/2009 and from that time forward, there have been
- 6 no new participants in the ESSRP.
- 7
- 8 Q. IF NO NEW PARTICIPANTS HAVE BEEN ADDED TO THE ESSRP, WHAT COSTS
- 9 CONTINUE TO BE INCURRED?
- 10 A. While new employees are not being added to the ESSRP, there are still ongoing benefits
- 11 being accrued for participants that entered into the plan.
- 12
- 13 Q. HAVE THESE ONGOING ESSRP COSTS BEEN INCLUDED IN RATES IN NORTH
- 14 DAKOTA?
- 15 A. Yes. As indicated in OTP's response to ND-02-098 in OTP's last rate case, included as
- 16 Exhibit\_\_\_(PEW-2), Schedule 1, the 2009 Test Year included costs associated with the
- 17 ESSRP. The settlement in Case No. PU-08-862 reflected an adjustment of \$150,668, but
- 18 there was no indication in the testimony of Mr. Majoros (filed on behalf of Staff) that the
- 19 adjustment was related to the ESSRP.
- 20
- 21 Q. ARE THE ESSRP COSTS INCLUDED IN THE 2018 TEST YEAR THE SAME TYPE
- 22 OF COSTS AS THE COSTS INCLUDED IN THE 2009 TEST YEAR?
- 23 A. Yes. Both Test Years reflect the costs associated with ESSRP benefits that participants
- 24 accrued. And it is a cost that has been included in our prior North Dakota rate
- 25 proceedings.

1 Q. DOES MR. SMITH RECOMMEND THE COMMISSION CHANGE COURSE AS IT  
2 RELATES TO ESSRP COSTS?

3 A. Yes. Mr. Smith now recommends the Commission disallow ESSRP costs from the 2018  
4 Test Year.<sup>1</sup>

5

6 Q. DO YOU AGREE WITH MR. SMITH'S RECOMMENDATION?

7 A. No. These are the same types of costs that were assessed in the 2008 Rate Case and  
8 included in rates. Mr. Smith provides no explanation as to why the Commission should  
9 now change course when there has been no underlying change in the ESSRP benefit for  
10 certain employees – again, these are the same types of expenses that accrued prior to our  
11 last rate case and have been included in rates.

12

13 Q. ARE THERE OTHER REASONS TO NOT ACCEPT MR. SMITH'S  
14 RECOMMENDATION?

15 A. Yes. The ESSRP is another component of a competitive overall compensation and  
16 benefits package for certain key executives and key management employees. As  
17 previously noted, compensation surveys have OTP executives and key management  
18 employees well below the market median, five percent below for total cash compensation  
19 and 12 percent below for total direct compensation. Although this benefit has been  
20 reduced in recent years and the program is closed to new employees, it formed part of our  
21 overall reasonable compensation and benefits package designed to retain quality  
22 leadership within OTP, and it should again be included as a reasonable expense within  
23 this rate case.

24 **C. Employee Stock-Based Incentive Compensation**

25 Q. WHAT IS MR. SMITH'S RECOMMENDATION AND YOUR RESPONSE AS TO  
26 THE EMPLOYEE STOCK-BASED INCENTIVE COMPENSATION?

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<sup>1</sup> Smith Direct, p. 52.

1 A. Mr. Smith recommends disallowing all such 2018 test year cost of service stock-based  
2 compensation expense. (Smith at 41:15-17).

3

4 Q. DO YOU AGREE WITH MR. SMITH'S RECOMMENDATION?

5 A. No. As noted previously within my Direct and Rebuttal Testimony, our total  
6 compensation approach is critical to attracting, retaining and engaging employees.  
7 Restricted Stock Units (RSU) are utilized for executives and key management employees  
8 and are a part of an overall compensation package. The Mercer Executive Compensation  
9 Survey, provided as an attachment to my Direct Testimony, and detailed earlier in this  
10 Rebuttal Testimony, shows that executives are well below the market median (-13%)  
11 when comparing to actual RSU earned by executives.

12

13 Q. ARE THERE OTHER REASONS WHY YOU DON'T AGREE WITH MR. SMITH'S  
14 RECOMMENDATION ON EMPLOYEE STOCK-BASED INCENTIVE  
15 COMPENSATION?

16 A. Yes. Due to the nature of the RSU compensation, OTP's program has a vesting period of  
17 four years. As a result, a person who has earned RSU is not eligible to receive the RSU  
18 for four years. If the person is no longer employed by our Company, unless they left due  
19 to retirement, disability or death, they are not able to receive the RSU. So, this type of  
20 longer-term compensation is really geared to be a retention tool and one that ensures  
21 people receiving this type of compensation are looking out for the longer-term benefit of  
22 the Company, positively benefitting our customers.

23 These types of longer-term incentives reward the creation of *sustained* performance  
24 and create a longer-term perspective, as a balance to the annual incentive programs, and  
25 in this instance used as a prudent retention tool as well. As with other longer-term  
26 incentives, in order to be competitive attracting and retaining key talent – the appropriate  
27 talent necessary to successfully operate the Company – it must offer some form or forms  
28 of long-term incentives to its executives as part of that planning. Again, the alternative is  
29 to either offer significant value in some other form of long-term incentive or replace that  
30 value through some other means (higher salaries, annual incentive, *etc.*). I noted in my

1 Direct Testimony that the purposes of OTP's long-term incentives are to: (1) link the  
2 long-term success of OTP to qualifying employee compensation; (2) encourage the  
3 retention of management over the long-term; and (3) provide the opportunity to earn  
4 competitive total compensation.

5 **D. Non-Employee Director Compensation**

6 Q. WHAT DOES MR. SMITH RECOMMEND REGARDING THE EQUITY  
7 COMPENSATION (NON-EMPLOYEE DIRECTOR RESTRICTED STOCK GRANTS)  
8 FOR THE BOARD OF DIRECTORS?

9 A. Mr. Smith recommends a disallowance of all these costs. (Smith, pp. 45-48), Mr. Smith  
10 states the equity compensation paid to the Otter Tail Corporation Board of Directors does  
11 not benefit customers and, he believes, "has the primary purpose of benefitting the parent  
12 company's shareholders" (Smith, p. 47). This argument in terms of customer versus  
13 shareholder interests is irrelevant in this context, sidestepping what are the relevant  
14 questions, namely: (1) whether the equity compensation is necessary; and (2) whether the  
15 compensation received by the Board of Directors is reasonable. I explain below that the  
16 answer to both questions is "yes", and, accordingly, these costs should be recovered in  
17 rates.

18

19 Q. IS THE COMPANY REQUIRED TO HAVE A BOARD OF DIRECTORS?

20 A. Yes. My understanding is that as a Minnesota corporation, Otter Tail Corporation is  
21 required to have a board of directors pursuant to Section 302A.201, Subd. 1, Minnesota  
22 Statutes. Paying compensation to the Board of Directors in exchange for the work they  
23 perform is reasonable and consistent with how boards of directors of other corporations  
24 are treated, including in the utility industry. Thus, the costs Mr. Smith seeks to disallow  
25 are necessary costs of Otter Tail Corporation being the parent company of OTP.

26

27 Q. WHAT PROCESS IS USED TO DEVELOP THE COMPENSATION THAT THE  
28 BOARD OF DIRECTORS EARNS?

1 A. Just as with our non-bargaining employee compensation, we also base our non-employee  
2 Director compensation on the market. As described in the 2018 Proxy Statement for  
3 Otter Tail Corporation, the Compensation Committee for the Board of Directors  
4 periodically reviews compensation practices to determine their competitiveness with  
5 market practices. A market analysis of Director compensation was conducted in 2017  
6 and it used data from the National Association of Corporate Directors and a peer group  
7 (listed on page 16 of the 2018 Proxy Statement). The Compensation Committee also  
8 used services provided by Willis Towers Watson, utilizing market data for other utilities.  
9

10 Q. HOW IS THE COMPENSATION PROVIDED TO THE NON-EMPLOYEE  
11 DIRECTORS?

12 A. The compensation provided to the Directors consists of two components: (1) an annual  
13 retainer; and (2) an annual, fixed equity grant of restricted stock, vesting over a period of  
14 three years (33.3 percent, per year), granted under the terms of the 2014 Stock Incentive  
15 Plan on the date of the Annual Meeting. Like most other boards of publicly-held  
16 companies, the Board Chair and those with committee assignments qualify for limited  
17 additional grants of restricted stock but on the same vesting schedule and voting rights as  
18 the base stock grant. I would also note that OTP customers are not paying for all these  
19 costs, as Mr. Smith notes (Smith, p. 48), because the blended North Dakota jurisdictional  
20 allocator is applied to these reasonable and required costs and only the allocated  
21 percentage is included in our North Dakota rates. Thus, OTP customers get the benefit of  
22 the Board but only pay for a percentage through the previously approved allocator.  
23

24 Q. IS PROVIDING COMPENSATION TO THE NON-EMPLOYEE DIRECTORS  
25 THROUGH CASH AND EQUITY A REASONABLE APPROACH?

26 A. Yes. This approach is consistent with industry best practices used by other utilities.  
27

28 Q. IS IT APPROPRIATE, AS MR. SMITH ATTEMPTS, TO DISALLOW THE EQUITY  
29 COMPENSATION COSTS FOR THE COMPANY'S NON-EMPLOYEE  
30 DIRECTORS?

1 A. No. The costs at issue are necessary, as they reflect compensation that is provided to our  
2 legally-required Board of Directors using industry best practices. Furthermore, the non-  
3 employee Director costs result from a comprehensive benchmarking process and,  
4 therefore, are reasonable. The use of stock grants is based on a combination of  
5 competitive practice and a desire to align the interests of the non-employee Directors  
6 with the long-term performance and success of the organization.

7 **IV. OTP'S "TOTAL COMPENSATION" APPROACH**

8 Q. PLEASE DESCRIBE OTP'S GENERAL APPROACH TO SETTING TOTAL  
9 COMPENSATION FOR EMPLOYEES.

10 A. It cannot be disputed that an effective compensation strategy is essential to any well-  
11 managed business. OTP is no exception in this regard. As I described in my Direct  
12 Testimony, OTP's compensation goals are to attract, retain and engage employees. We  
13 do this by utilizing a total compensation package that appropriately balances base pay  
14 and benefits, along with "at risk" pay that can be earned through short-, and in some  
15 cases, long-term incentives. This is accomplished by providing a compensation package  
16 that is competitive with the market, internally fair and equitable, and that supports the  
17 Company's near-term and long-term business goals while consistently meeting its  
18 requirements to provide safe, reliable and cost-effective service to our customers. We  
19 design those programs to minimize costs while allowing the Company to attract and  
20 retain the qualified employees required to deliver that safe, reliable and cost-effective  
21 electric service to our customers.

22 We know that the retention and motivation of quality employees directly benefits  
23 our customers. We have seen that our incentive compensation approach – providing  
24 incentives and linking pay to performance – impacts our overall performance, in areas  
25 ranging from quality of work and productivity to customer satisfaction and limiting  
26 unwanted turnover. Motivated employees ensure we exceed operational excellence and  
27 they directly impact our ability to provide safe, reliable service at reasonable and  
28 competitive prices for our customers. We also believe that providing a competitive total

1 compensation package allows us the best opportunity to attract, retain and engage quality  
2 employees, and that those quality employees make sure that we deliver on our Mission.

3 The design of our compensation program encourages going over-and-above basic  
4 job descriptions, rewarding that extra “stretch.” And from the customers’ perspective,  
5 putting some portion of pay at risk also produces tangible benefits ranging from fewer  
6 employees needed to conduct the same operations, to better customer service and  
7 generating unit performance, with a workforce that efficiently meets service/safety  
8 commitments and finds efficiencies in other areas, all of which, again, ultimately lowers  
9 costs to customers.

10 Utility management must set its total compensation to be reasonable and must  
11 also have the tools within that framework of reasonable overall compensation to best  
12 craft compensation strategies in order to attract, engage and retain quality employees.  
13 Stretch targets for employees, including management, are common and when the  
14 performance merits it, are a normal component of reasonable compensation. To do this,  
15 we balance annual incentives, with their focus on employee efforts toward operational  
16 excellence, with longer-term incentives which are focused more on retention that directly  
17 benefits the stewardship of our service which will ensure long-term financial success.  
18 Both are common in the industry. Variable pay has many advantages over other forms of  
19 compensation:

20 ➤ Costs associated with variable pay can be, and in OTP’s case, are, aligned with  
21 performance; employees and the Company as a whole must “re-earn” the reward  
22 every year. If the sought level performance is not maintained or an employee  
23 leaves, variable pay can be reduced or eliminated.

24 ➤ Variable pay targets compensation dollars to the right people and ensures top  
25 performers can be rewarded for their performance. A well-designed incentive  
26 compensation program offers more opportunity and will attract high performers  
27 who are confident of their abilities. It can also motivate supporting each other  
28 and working cooperatively toward common objectives. In a 2017 employee  
29 engagement survey, compiled by IBM/Kenexa, 87% of our employees agree with  
30 the statement, “The people I work with cooperate and get the job done.” That  
31 number was four points higher than the IBM Norm and it represents a workforce  
32 committed to meeting our Mission.

1           ➤ Retention of talent is also improved, both through financial incentives and  
2 through clear communication of what is expected from an individual, especially  
3 with respect to management and executives. Executives know exactly what is  
4 expected of them and know this performance will be rewarded.

5           ➤ The motivational potential of variable pay is stronger than that of other forms  
6 of compensation. It creates a performance culture, not an entitlement culture. It  
7 creates a sharp focus on priorities and enables people to continuously evaluate and  
8 improve results.

9           ➤ Variable pay is one of the strongest ways we can send signals about what is  
10 important, providing alignment and motivating commitment to our overall  
11 Mission and values. Key priorities can be identified, optimized and clearly  
12 understood. Through continuous measurement of results, high quality feedback is  
13 can also be provided. Employees are the most engaged when they have a clear  
14 understanding of what is expected, and when they are getting feedback on how  
15 they are performing against their peers.

16           Based on our record of low rates and quality service, we are demonstrating on a  
17 daily basis that our incentive compensation formula is a valuable tool to sustain excellent  
18 employee performance. There is no question the access to reliable, affordable power is a  
19 significant enticement to existing and new commercial activity in North Dakota, which  
20 broadly benefits all North Dakotans. Equally clear, Mr. Smith's proposals to deny cost  
21 recovery threatens the long-supported discretion OTP has had – within the bounds of  
22 reasonable overall compensation – to design and implement effective compensation for  
23 our executives and employees. The Company strongly believes that its comprehensive  
24 approach across the enterprise and the flexibility it has had in assigning criteria that  
25 employees must meet in order to receive the incentive pay are critical to the overall  
26 success of our compensation program.

27

28 Q.    ARE INCENTIVE PLANS AN APROPRIATE PART OF TOTAL COMPENSATION?

29 A.    Yes. Mr. Smith's adjustments, in my view, do not reflect a full understanding of the  
30 important role incentive compensation plays in meeting the goals of the OTP's  
31 compensation program. It is evident that incentive plans are a normal, prudent and  
32 appropriate expense for businesses. They are common in the utility industry and in  
33 private-sector employment more generally, and as I noted earlier, serve the purpose of

1 sending appropriate financial signals to employees and management that striving for and  
2 reaching those higher results are actions worth compensating.

3

4 Q. WHAT IS YOUR ROLE IN THIS PROCESS?

5 A. As Director, Human Resources and Safety, I am directly involved with the Company's  
6 process that includes, as a goal, setting compensation levels (including incentives) that  
7 are responsive to market conditions so that, again, we can attract, engage and retain  
8 qualified employees who can help us provide safe, reliable utility service at a reasonable  
9 cost. This philosophy is not casually determined. We must compete in today's labor  
10 market. Aside from compensation, we must offer above all a safe workplace. That is  
11 also a key part of my job. We certainly are also proud of living in such a beautiful part of  
12 the country, and think we share the toughened, hardworking and frugal values of our  
13 customers who are attached and vested in the quality of life in our communities. But  
14 today's access to information also requires we maintain a competitive posture accurately  
15 pegged to the labor market. Balancing this desire is the need to maintain a cost-effective  
16 labor component so as not to take away resources from other utility business needs, such  
17 as maintenance and infrastructure. This need to balance our employee/labor costs places  
18 a high priority on my role in the organization in keeping its finger on the pulse of the  
19 labor market and business needs, and in designing and implementing a competitive and  
20 cost-effective total compensation program. As to my part in that role, I strive to balance  
21 the costs of attracting, engaging and retaining a quality workforce along with the costs we  
22 ask our customers to pay for the services we provide.

23

24 Q. HOW DOES OTP TOTAL COMPENSATION COMPARE TO MARKET SURVEY  
25 DATA?

26 A. In my Direct Testimony, we provided Schedules 2 and 3 which detail benchmark  
27 compensation information from a 2015 Mercer compensation study. Schedule 2  
28 pertained to non-union employees across OTP and Schedule 3 covered executive  
29 compensation. Schedule 2, on page 32, shows that our short-term incentives provided  
30 under the Key Performance Award Plan are seven percent below the market in aggregate.

1 In fact, the Mercer data shows the 25<sup>th</sup> percentile of the market is at seven percent, which  
2 is one percent above our maximum benefit under the KPA. To reach the 50<sup>th</sup> percentile of  
3 the market, we would need to be targeting our short-term incentive at 11 percent.  
4

5 Q. ACCORDING TO THE MERCER STUDY (SCHEDULE 2), IS THE KPA PLAN  
6 REASONABLE COMPARED TO THE DATA WITHIN THE MERCER STUDY?

7 A. Yes. In fact, the Mercer data shows that our KPA target is actually seven percent below  
8 the market average.  
9

10 Q. WHAT DOES THE MERCER STUDY (SCHEDULE 2) SHOW FOR TOTAL  
11 COMPENSATION?

12 A. The Mercer data shows that our aggregate total compensation (base salary + short-term  
13 incentive) was one percent above the market average.  
14

15 Q. DOES MR. SMITH RECOMMEND ANY REDUCTIONS TO THE KPA?

16 A. No, he does not.  
17

18 Q. BASED ON THE MERCER STUDY (SCHEDULE 2), IS OTP TOTAL  
19 COMPENSATION APPROPRIATE?

20 A. Yes. In order for our company to attract, engage and retain employees, we need to have a  
21 total compensation package that is competitive. The Mercer data shows that our base  
22 salary is slightly higher than the market median, and that our short-term incentive, or at  
23 risk pay, is lower than the market. Together, our total compensation is competitive,  
24 allowing us to continue to attract, retain and engage quality employees, and at a  
25 reasonable cost to our customers.  
26

27 Q. HOW DOES EXECUTIVE COMPENSATION, DETAILED IN THE MERCER  
28 STUDY (SCHEDULE 3), COMPARE TO THE MARKET/

29 A. The Mercer study shows that, in aggregate, our executive compensation compares in the  
30 following way:

1	<i>Base Salary</i>	<i>4% below the Market Median Index</i>
2	<i>Target Total Cash Compensation</i>	
3	<i>(Base Salary + Short-term Incentive)</i>	<i>5% below the Market Median Index</i>
4	<i>Target Total Direct Compensation</i>	
5	<i>(Base + STI + Long-term Incentive)</i>	<i>12% below the Market Median Index</i>
6		

7 The information provided by Mercer’s study showed that OTP executives, in the overall  
8 aggregate for short-term incentives provided within the Management Incentive Plan  
9 (MIP), were one percent over the market median.

10

11 Q. BASED ON THE MERCER STUDY, IS THE OTP EXECUTIVE TOTAL  
12 COMPENSATION COMPETITIVE WITHIN THE MARKET?

13 A. Yes. The Mercer study, on page 17, notes, “In aggregate, compensation is aligned to the  
14 competitive range for base salary and target total cash compensation (+/- 10 percent of  
15 market median).” The Mercer study, also on page 17, also provides, “In aggregate, target  
16 total direct compensation falls around the minimum of the competitive range (+/- 15  
17 percent of market median). Excluding the President, the aggregate market median index  
18 is 83%, which is 2% below the competitive range.”

19

20 Q. IS IT IMPORTANT FOR OTP TO ATTRACT, ENGAGE AND RETAIN QUALITY  
21 EXECUTIVES AND KEY MANAGEMENT PERSONNEL? WHY?

22 A. Yes, employees are the distinguishing factor for companies, and their ability to meet their  
23 Mission. And the leadership at a company will set the tone for how the entire  
24 organization will operate. At OTP our Mission is to produce and deliver electricity as  
25 reliably, economically, and environmentally responsibly as possible to the balanced  
26 benefit of customers, shareholders, and employees and to improve the quality of life in  
27 the areas in which we do business. Although it is not an easy Mission, our employees  
28 show up every day to try meet it. One of the ways we’re able to be successful most days  
29 is because of the loyalty shown by our employees. Our customers benefit from that, and  
30 they benefit from workforce continuity. Reliability of our electrical plants and electrical  
31 systems are enhanced because of the technical knowledge and experience that are

1 paramount to operating a reliable electric system that spans a 70,000 square-mile area.  
2 With increased turnover, meaning we have less experienced employees, our institutional  
3 knowledge would decrease which could translate into a degradation to the quality electric  
4 service we strive to provide for our customers. Having a stable workforce, at all levels of  
5 the Company, helps us to meet our Mission and we do it by trying to provide competitive  
6 total compensation to our employees while maintaining a competitive price and reliable  
7 service to our customers. The Company has a reasonable and competitive total  
8 compensation approach that is in line with peer data. Being competitive with our total  
9 compensation is critical for competing in this labor market, and for providing quality  
10 service to our customers at a reasonable price.

11 **V. CONCLUSIONS**

12 Q. WHY SHOULD THE COMMISSION ALLOW OTP TO FULLY RECOVER  
13 REASONABLE TOTAL EMPLOYEE COMPENSATION COSTS, INCLUDING PAY  
14 AT RISK COMPONENTS?

15 A. Reasonable total compensation includes many components. Annual incentives and long-  
16 term incentives are critical components of a balanced, performance-sensitive  
17 compensation program, and they have been effective in our efforts to provide quality  
18 service in a cost-effect manner to our customers. Pay at risk is a critical tenant of pay for  
19 performance culture. It is an important tool for us to attract and retain talented  
20 employees, and as such its value is recognized and common throughout our industry. It  
21 is, for me personally, a catalyst for continuing and improving strong performance to the  
22 benefit of the utility's customers. And I have seen it working with our employees  
23 including our management team. The Commission should make an assessment of the  
24 overall compensation and benefit package that is offered by OTP, and if it is reasonable,  
25 it should be approved. There should be no disallowance as Mr. Smith advocates for,  
26 divorced from an assessment of the overall cost of these employees.

1 Q. SO, IS THE OTP ANNUAL INCENTIVE PLAN WORKING IN TERMS OF  
2 OPTIMIZING PERFORMANCE AND TALENT?

3 A. Yes, it certainly is. Optimizing performance and attracting, retaining and engaging talent,  
4 signaling and aligning goals, encouraging safety and compliance ... all translate into real  
5 benefits to our customers. As I first noted in my direct testimony (Wasberg Direct, p.5),  
6 “Combining financial criteria, along with performance measures, ensures that we  
7 maintain the balance between reliable service and reasonable prices. We believe in this  
8 balance and that the financial criteria provide a benefit to our customers.” OTP continues  
9 to maintain that it has structured a reasonable total cash compensation and benefits  
10 package that is needed to attract and thereafter engage and retain talented employees  
11 necessary to provide high quality electric service to our customers. This includes base  
12 salaries, active and post-retirement benefits, and incentive compensation (*i.e.*, that a  
13 portion of total compensation is “at risk” for employees). OTP’s proposed compensation  
14 and benefit costs are fair and reasonable and should be included in rates.

15 As OTP’s Director, Human Resources and Safety, I know first-hand that it is  
16 working and working well. We have been able to attract, engage and retain quality  
17 employees at a reasonable cost while remaining generally competitive with the market.  
18 We are successfully meeting our Mission and providing benefits to stakeholders,  
19 including our customers. In direct response to the treatment sought by Mr. Smith, I would  
20 hope the Commission sees the benefits the Company’s approach brings to our customers  
21 and views compensation within the context of the overall pay being reasonable and near  
22 market. Within that context, there should also be recognition that the way OTP has  
23 tailored its incentive compensation plans to best incent our employees and management,  
24 and that this carefully-designed approach should be recognized for the benefits it does  
25 provide to our customers who have some of the lowest rates, not only within this region,  
26 but across the entire United States.

27  
28 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY, MR. WASBERG?

29 A. Yes, it does.

TRADE SECRET

Information Request No. ND 02-098

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Otter Tail Corporation d/b/a  
OTTER TAIL POWER COMPANY  
North Dakota Case No: PU-08-862

Response to: North Dakota Public Service Commission  
Analyst: Diller\_King\_02  
Date of Request: 1/28/2009  
Date Received: 1/28/2009  
Date Due: 2/27/2009

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Information Request No. ND 02-098

Please provide the total expense related to any Deferred Compensation Plans and Supplemental Executive Retirement Plans (SERP) included in the revenue requirement and explain where these amounts can be found in the revenue requirement schedules and workpapers. Also, provide all allocation factors used, along with the calculation of those factors and an explanation of what they are and why they are the appropriate factor to use.

**RESPONSE:**

Deferred compensation plans

1. **[TRADE SECRET DATA BEGINS... ...TRADE SECRET DATA ENDS]** was recognized as expense in account 557 in 2007 under the Power Services deferred compensation plan.
2. 2007 expense for restricted stock was \$370,738, and it was recorded in account 921.

Executive Survivor and Supplemental Retirement Plan

The Utility's 2007 net periodic benefit cost for the Executive Survivor and Supplemental Retirement Plan was \$1,341,430 and it was recorded in account 926. In addition, the Utility was allocated \$484,754 by Otter Tail Corporation for the Executive Survivor and Supplemental Retirement Plan. The amount allocated by Otter Tail Corporation was recorded in these accounts: 426.5 - \$1,771 and 920 - \$482,983.

Please refer to Attachment 1 to IR ND 02-098 for the calculation of the amounts included in North Dakota revenue requirements, the allocation factors used and the location in the JCOSS where these amounts can be found. The operating expenses in the JCOSS are located in Volume 4A, Tab – Test Year Work Papers, Tab – JCOSS, Pages 10-11.

Responding Witness: Pete Beithon  
Title: Manager, Regulatory Economics  
Department: Regulatory Services  
Telephone: (218) 739-8607  
Date of Response: 2/23/2009

TRADE SECRET

Information Request No. ND 02-098

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Volume 4A, Tab – Test Year Work Papers, Tab – JCOSS, pages 16-17 list the allocation factors that apply and the calculation of these factors can be found in the working copy of the JCOSS model submitted with the response to IR 01-035. Please refer to Volume 2A, Tab – Peter Beithon, Exhibit\_\_(PJB-1), Schedule 11B for a description of the allocation factors being used.

Responding Witness: Pete Beithon  
Title: Manager, Regulatory Economics  
Department: Regulatory Services  
Telephone: (218) 739-8607  
Date of Response: 2/23/2009