Peter Wasberg

Volume 2B

Direct Testimony and Supporting Schedules:

Peter Wasberg

Employee Compensation

Before the South Dakota Public Utilities Commission

State of South Dakota

In the Matter of the Application of

Otter Tail Power Company

For Authority to Increase Rates for Electric Utility

Service in South Dakota

Docket No. EL10-_____

Exhibit___

EMPLOYEE COMPENSATION

DIRECT TESTIMONY AND SCHEDULES OF

PETER E. WASBERG

August 20, 2010

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Schedule 1 – Qualification, Duties and Responsibilities of Peter E. Wasberg
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I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Peter E. Wasberg. My business address is 215 South Cascade Street, Fergus Falls, MN, 56537.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT POSITION?

A. I am employed by Otter Tail Power Company ("Otter Tail Power" or "OTP") as the Director, Human Resources and Safety.

Q. PLEASE SUMMARIZE YOUR QUALIFICATIONS AND EXPERIENCE.

A. A description of my qualifications and experience is attached as Exhibit ___, (PEW-1) Schedule 1.

Q. FOR WHOM ARE YOU TESTIFYING?

A. I am providing testimony on behalf of OTP.

Q. WERE THE ATTACHED SCHEDULES PREPARED EITHER BY YOU OR UNDER YOUR SUPERVISION?

A. Yes.

II. PURPOSE AND SCOPE OF TESTIMONY

Q. WHAT IS THE PURPOSE AND SCOPE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to discuss matters related to employee compensation and benefits for OTP. First, I will discuss how the compensation levels provided by OTP compare to the general market. Second, I will briefly describe OTP's current compensation plan, including its two annual incentive plans (collectively the "OTP Annual Incentive Plan"). Third, I will generally describe the compensation and benefit costs that are included in the revenue requirement. Finally, I will provide a summary of OTP's post retirement medical and pension plans and their reasonableness.

Q. PLEASE SUMMARIZE OTP'S PROPOSAL.

A. As generally described in my testimony and further discussed by Mr. Peter J. Beithon, OTP requests recovery of: (i) costs of wages and salaries and current employee benefits; (ii) costs of the OTP Annual Incentive Plan based on a five-year average payout level for non-union employees and 2009 actual payout levels for key management employees, both of which are subject to a cap of 25 percent of individual employees' base salary; and (iii) costs relating to post retirement benefits.

Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

A. In Section III, I discuss OTP compensation levels and the competitive market. Section IV includes a description of OTP's workforce and compensation plan. Section V provides a description of OTP's employee benefits. Section VI describes the costs included in the test year revenue requirement, and Section VII provides my conclusion.

III. OTP COMPENSATION LEVELS AND THE COMPETITIVE MARKET

Q. DOES OTP USE INFORMATION REGARDING COMPENSATION AT OTHER FIRMS IN CONNECTION WITH ITS COMPENSATION DECISIONS?

A. Yes. OTP routinely compares its compensation levels to those of other utilities and some non-utilities, using a number of surveys and information sources including Towers Perrin, Mercer, and Hewitt. Every three years, OTP participates in a benchmark study for non-executive employees. The two most recent Benchmark Studies, completed in 2005 and 2008, were conducted by Towers Perrin (now Towers Watson). We also routinely review collective bargaining agreements from other utilities throughout the region.

Q. PLEASE EXPLAIN HOW OTP USES THIS INFORMATION.

A. OTP uses this information as the framework for formulating its compensation programs. Salary surveys are reviewed and analyzed to find positions that correspond with the essential job duties, skills, and functions of OTP's positions. The appropriate benchmark market and salary range for OTP positions are then derived from the median of the applicable survey data. While the market based compensation for a position is based on the median, it is not limited to the single data point of the median. Rather, the relevant market for a position includes a range above and below the median. The compensation for OTP non-union employees is ultimately determined by a combination of market data and the employee's responsibilities, performance, and experience.

Q. PLEASE FURTHER EXPLAIN THE MOST RECENT TOWERS PERRIN BENCHMARK STUDIES FOR NON-EXECUTIVE EMPLOYEES.

A. In 2005 and 2008, Benchmark Studies were conducted by Towers Perrin for non-executive employees that included compensation for a broad sample of positions. OTP compensation levels were compared using a combination of general industry, energy/utility industry, and north central regional data to reflect the labor markets in which OTP competes.

Q. WHAT WERE THE RESULTS OF THE BENCHMARK STUDY?

A. The 2005 and 2008 Towers Perrin Benchmark Studies showed the following:

1. In the 2005 Study: (i) OTP base salaries overall were 5 percent below the competitive median; and (ii) total cash compensation levels (base salary plus annual incentive) overall were 4 percent below the competitive median.
2. In the 2008 Study: (i) OTP base salaries were 1.9 percent below the competitive median; and (ii) total cash compensation levels overall were 5.8 percent below the competitive median in the 2008 Benchmark Study.

Q. WHAT DID YOU CONCLUDE FROM THESE RESULTS?

A. The 2005 and 2008 Benchmark Studies indicate that our salary structure included in our rate request for non-executive employees is competitive, although slightly below the market median.

Q. DID TOWERS PERRIN ALSO CONDUCT A STUDY OF OTP EXECUTIVE COMPENSATION?

A. Yes. In 2007, Towers Perrin conducted a study of executive compensation for OTP, which included consideration of a number of topics, including the following:

1. Base salary levels;
2. Total cash compensation levels (including base salaries plus annual incentive targets); and
3. Total direct compensation levels (including base salaries, annual incentive compensation, and long-term incentives).

Q. WHAT DID THE STUDY SHOW?

A. The Study showed the following:

1. OTP base salaries were 22 percent below the competitive median;
2. OTP's actual total cash compensation was 42 percent below the competitive median; and
3. Total direct compensation was 51 percent below the competitive median.

Q. DID OTP MAKE ADJUSTMENTS AS A RESULT OF THE STUDY?

A. As a result of the Study, adjustments to compensation for OTP executives were made effective as of April, 2007.

Q. DOES OTP EXECUTIVE COMPENSATION REMAIN BELOW THE COMPETITIVE MARKET MEDIANS AFTER THESE ADJUSTMENTS?

A. Yes. Even with the adjustments made in April, 2007, OTP's overall total cash compensation for 2007 (including base salary plus *target* annual incentives) for OTP executives was still 21 percent below the competitive market median and total direct compensation was still 33 percent below the market median. OTP did not do an executive compensation study in 2008 or 2009, but we did review data from the WorldatWork 36th Annual Salary Budget Survey ("WorldatWork Survey"). The WorldatWork Survey reported Total Salary Budget Increases for executives at 4 percent in 2008 plus 3 percent for 2009. OTP increased executive pay by approximately 5 percent in 2008 but did not increase executive pay in 2009. Based on this information, it is my conclusion that OTP executive compensation remains below the competitive market median.

IV. OVERVIEW OF OTP'S WORKFORCE AND COMPENSATION PLAN

Q. PLEASE BRIEFLY DESCRIBE OTP'S WORKFORCE.

A. As of December 31, 2009, OTP had 779[1] full-time employees, including approximately 416 union employees and 363 non-union employees (not adjusted for employees of jointly owned plants), and 25 part-time employees. These employees provide a wide range of services required to provide electric utility services to our approximately 129,000 customers located in South Dakota, Minnesota and North Dakota.

Q. WHAT ARE OTP'S COMPENSATION GOALS FOR ITS WORKFORCE?

A. OTP's compensation goals are to attract, and thereafter retain and motivate, valuable employees. Such employees are essential to achieve OTP's mission, which is to produce and deliver electricity as reliably, economically and environmentally responsibly as possible to the balanced benefit of customers, shareholders, and employees, and to improve the quality of life in the areas in which we do business. OTP focuses on maintaining a compensation program that provides a competitive, performance-based pay system that helps us attract and retain a quality workforce that provides our customers with safe, reliable, and economical service.

[1] The employee count of 723 in the direct testimony of Mr. Thomas R. Brause represents the number of full time equivalent employees, which has been adjusted for jointly owned plants.

Q. IS OTP FACING CHANGES THAT INCREASE THE IMPORTANCE OF THESE GOALS?

A. Yes. We expect to have over 40 percent of our employees retire within the next 10 years, which makes these goals even more critical to our ability to provide safe, reliable, and economical service.

Q. WHAT ARE THE MAIN COMPONENTS OF OTP'S COMPENSATION PLAN?

A. The OTP compensation plan for many employees consists of a combination of base salaries and annual incentive compensation, along with standard employee benefit plans, including a retirement savings plan, an employee stock ownership plan, and health and dental plans. OTP also provides post retirement pensions and health benefits. Some key management employees are also eligible for long-term incentives.

Q. PLEASE BRIEFLY DESCRIBE THE OTP ANNUAL INCENTIVE PLAN.

A. The OTP Annual Incentive Plan includes all regular employees who are not represented by a union and who work at least 1,000 hours per year. The OTP Annual Incentive Plan includes separate plans for: (i) non-union employees (the "OTP Key Performance Award Plan" or "OTP KPA Plan"); and (ii) key management employees (the "OTP Management Plan").

Q. PLEASE BRIEFLY DESCRIBE THE OTP KPA PLAN.

A. The OTP KPA Plan includes approximately 388 OTP non-union employees. The maximum payout level is 6 percent of the respective individual employee's base salary. The OTP KPA Plan includes: (i) four operating criteria (safety, customer satisfaction, equivalent plant availability, and reliability based on the average outage minutes per customer); and (ii) one financial criterion relating to the control of operation and maintenance ("O&M") costs. Each of these five criteria has a weighting. The four operating criteria each have a weighting of 1 percent. The O&M cost criteria has a weighting of up to 2 percent. Payouts under the operating criteria are not financially tied to the O&M criterion.

Q. PLEASE BRIEFLY DESCRIBE THE OTP MANAGEMENT PLAN.

A. The OTP Management Plan includes 19 OTP employees. Four OTP management employees had target maximum payout levels that exceed 25 percent, but OTP is proposing to limit the level of incentive compensation recovered in rates to 25 percent of their individual salaries. The OTP Management Plan includes a number of individual criteria that vary by the employee's job and responsibilities, and two overall financial criteria relating to OTP. The individual criteria have a cumulative weighting of 40 percent. The financial criteria have a weighting of 60 percent.

Q. HOW DOES THE OTP ANNUAL INCENTIVE PLAN FIT INTO OTP'S TOTAL COMPENSATION PLAN?

A. The OTP Annual Incentive Plan is an important part of our total compensation plan. The annual cash incentive compensation that is part of the OTP Annual Incentive Plan encourages increased productivity, and enables OTP to first attract, and then retain and motivate, quality employees by rewarding employees for providing quality service to our customers. Both customers and employees benefit from setting incentives that tie directly to our customers' needs.

The OTP Annual Incentive Plan helps us to maintain workforce continuity. Reliability of our electrical plants and electrical systems is maximized when we have continuity in our workforce. The technical knowledge needed, and the years that it actually takes to acquire the specialized skills for our system, are paramount to our ability to reliably and efficiently provide energy to our customers. Our low turnover rate, helped by a competitive compensation and incentive package, has increased our ability to maintain a strong system without higher employee counts. Our customers also see the advantages of reduced costs associated with the lower recruitment and training requirements associated with a stable workforce.

The financial performance components of the OTP Annual Incentive Plan also benefit customers because financial performance depends on the prudent management of costs, which allows electric utility service to be provided at reasonable prices. With an expected retirement rate of over 40 percent in the next 10 years, we see maintaining a competitive compensation package as a critical requirement for our customers and company.

Q. WHAT IS THE ALTERNATIVE TO THE USE OF ANNUAL INCENTIVE COMPENSATION IN OTP'S COMPENSATION PACKAGE?

A. Without annual incentive compensation, the only way to maintain a competitive cash compensation package would be to increase base salaries, which would increase other costs and substantially reduce both flexibility and incentives for performance.

Q. PLEASE DESCRIBE OTP'S LONG-TERM INCENTIVES?

A. The OTP long-term incentives are considered along with other components of compensation when we review compensation levels, including the 2007 Towers Perrin study on executive compensation. The purposes of OTP's long-term incentives are to: (i) link the long-term success of OTP to qualifying employee compensation; (ii) encourage the retention of management over the long-term; and (iii) provide the opportunity to earn competitive total compensation. The main components of OTP's long-term incentives are grants of restricted stock and stock options. Qualifying employees are awarded restricted stock units and options based on salary, job level, and the price of the stock at the date of grant.

Q. DO OTP LONG-TERM INCENTIVES PROVIDE BENEFITS TO RATEPAYERS?

A. Yes. Long-term incentives are part of OTP's total compensation package, which allow OTP to attract, and thereafter retain, its executive employees and key management. OTP's long-term incentives provide an added incentive to management employees to innovate and control costs, improve effectiveness, and improve customer satisfaction. As a result, ratepayers receive better service at a reasonable cost.

V. EMPLOYEE BENEFITS

Q. DOES OTP PROVIDE EMPLOYEE MEDICAL/DENTAL BENEFITS, PENSIONS AND OTHER POST RETIREMENT EMPLOYEE BENEFITS ("OPEBs")?

A. Yes. OTP provides Employee Medical/Dental Benefits, Pensions, and OPEBs.

Q. IS IT NECESSARY FOR OTP TO PROVIDE THESE BENEFITS?

A. Yes. OTP and its customers are directly benefited by having a stable, long-term workforce. In an industry where multiple years of training are required for employees to work independently, it is more fiscally prudent to have a workforce with a turnover rate that is low. As we retire over 40 percent of our workforce within the next ten years, it will be increasingly important for OTP to attract and retain a workforce that will continue to provide electricity to our customers in a safe, reliable, and efficient manner. OTP's benefits contribute to attracting and retaining its skilled workforce.

Q. PLEASE DESCRIBE OTP'S PENSION PLANS AND OPEBs.

A. OTP has three separate defined benefit pension plans: (i) a plan for union employees, other than those at the Coyote Station; (ii) a separate plan for union employees at Coyote Station; and (iii) a plan for nonunion employees. A summary description of OTP's pension plans is provided in Exhibit __ (PEW-1), Schedule 2. The OTP pension plans are funded through an external trustee. OTP also provides a medical benefits program for retirees.

Q. WHAT HAS OTP DONE TO MANAGE THE ESCALATING COST OF ITS PENSIONS AND OPEBs?

A. OTP has taken several steps to control costs of its pensions and OPEBs. OTP has switched from a defined benefit pension plan to a defined contribution pension plan for non-union employees starting employment after August 31, 2006 and for employees within one of our collective bargaining units starting employment after December 31, 2008.

Participation in OPEBs is limited in several ways. Participation for non-union employees is limited to persons hired before September 1, 2006. Participation for our Coyote Station collective bargaining agreement is limited to persons hired before January 1, 2009. Participation is also limited to persons who are age 55 or older at retirement with 10 or more years of service, and are eligible for or enrolled in the OTP medical program as of retirement.

We have also made substantial efforts to control employee counts, which reduces the costs of both pensions and OPEBs. We have negotiated caps and reductions in OTP's obligations in our union contracts. In addition, we have increased the amount of retiree contributions to the costs of the medical benefits program.

Q. IS OTP TAKING OTHER STEPS TO CONTROL THE COSTS OF ITS BENEFITS?

A. Yes. OTP has undertaken, and will continue to undertake, measures that are intended to reduce the rate of increase on active medical/dental benefit costs and OPEBs. In 2005, OTP was able to implement a cost-sharing mechanism for our active medical plan, including a15 percent cost-share by employees, with all five of the unions that represent OTP employees. We believe that this agreement mitigated cost increases in 2009 and 2010. We were also able to negotiate co-pay increases for certain medical expenditures, including brand prescription drugs, office visits, and chiropractic. We have also increased generic prescription usage from 55 percent to 61 percent since 2006, saving approximately $250,000 per year.

During our 2009 negotiations, we were unable to reach agreement on medical plan changes for our active or retiree plans, but discussions are continuing in an effort to save costs. Options that were considered for the active medical plan include a high deductible healthcare plan (HDHP) option with a health savings account (HSA). For the retiree plan, OTP intended to discontinue the option for any new hires, as we had previously done with new non-union employees and new union employees within the Coyote Station collective bargaining agreement. Challenges within the negotiations, and the prospect of Federal healthcare legislation, caused a temporary halt in these efforts. However, we have resumed discussions as part of our 2010 contract negotiations, to work toward changes that will benefit our company, employees, and customers. Dental costs have not increased over the past three years, and OTP negotiated a move to a new administrator in 2010 to hold dental spending stable for years 2010, 2011 and 2012. Dental coverage is only available to active employees.

Q. HAVE COSTS CONTINUED TO INCREASE DESPITE THESE EFFORTS?

A. Yes. Cost increases related to Pension, Retiree Medical, and Long Term Disability Medical are a reflection of: (i) our employee population, with half of the workforce at 47 years of age or older; and (ii) cost increases within the medical industry. We continue to work with our other four Unions to promote the same changes for future employees represented by those Unions, but the cost savings that will be recognized as a result of these changes will not be seen in the short-term. The OTP Pension Plan is designed for more significant benefits to long-term employees, and the Post Retiree Medical benefits do not start accruing until an employee reaches age 45. As a result, we will not see short-term cost savings, but it will reduce cost increases for our customers in the long-term. We are also seeing an increase to FAS 106 (post-retirement benefits other than pensions) expenses that are a direct result of our aging workforce. We have also seen an increase in FAS 112 (post-employment benefits) expenses due to our aging workforce.

Q. YOU HAVE EXPLAINED WHY CURRENT OPEBS ARE REASONABLE. WERE THE OPEBS THAT ARE BEING RECOVERED THROUGH THE FAS 106 TRANSITION AMORTIZATION ALSO REASONABLE?

A. Yes. At the time FAS 106 accrual accounting was put into place in 1993, we were required to convert our future OPEB obligations into a current expense and we were allowed to amortize that expense over a period of 20 years. Thus, the current 2009 revenue requirement includes the amortization of that transition obligation. OTP then, as now, offered a total compensation package, including OPEBs, set at an overall level needed to compete for and retain qualified employees. The OPEBs were limited to medical and life insurance benefits. A review of the OPEBs then available shows them to be very basic, e.g. eligibility was set at age 55 with 10 years of service, a reasonable deductible of $300 per individual was included and payment was limited to 80 percent for the next $7,500 of expenses, and the amount of lifetime payments was capped.

VI. COSTS INCLUDED IN THE TEST YEAR REVENUE REQUIREMENT

Q. PLEASE IDENTIFY THE COSTS OF OTP'S COMPENSATION PLAN THAT ARE INCLUDED IN THE REVENUE REQUIREMENT.

A. As further described by Mr. Beithon, OTP is seeking recovery of: (i) costs of base salaries; (ii) costs of current employee benefit plans; (iii) costs of the OTP Annual Incentive Plan, with the KPA Plan based on five-year average payout levels, and the Management Plan subject to a cap based on 25 percent of employees' salaries; (iv) long-term incentives for certain OTP employees; and (v) costs relating to pensions and other post retirement benefits. The 25 percent cap on the levels of annual incentive compensation applies to both OTP employees and Otter Tail Corporation employees. No long-term incentive compensation costs for Otter Tail Corporation employees have been included in the revenue requirement.

Q. HOW WAS THE BASE SALARY COMPONENT OF THE REVENUE REQUIREMENT DETERMINED?

A. The base salary component of the revenue requirement was based on 2009 actual levels, adjusted for increases in 2009 and 2010 compensation for both union and non-union employees, which will be known and measureable during 2010 and estimated for 2011.

Q. PLEASE FURTHER DESCRIBE THE 2010 AND 2011 INCREASE FOR UNION EMPLOYEES.

A. OTP has two collective bargaining agreements (CBAs) representing approximately 416 union employees: (i) a CBA with four IBEW Local Unions representing approximately 353 employees; and (ii) a CBA with one IBEW Local Union representing approximately 63 Coyote Station employees. The Coyote Station CBA was negotiated in 2008, prior to the current economic crisis, with an annual increase of 4 percent, effective September 1 for each year through August 31, 2011. The CBA for the other four IBEW Local Unions was negotiated in 2009 resulting in a one-year contract with a 2 percent wage increase, retroactive to November 1, 2009, and in effect until October 31, 2010. The revenue requirement reflects the 2009 annualized pay increase for the Coyote Union employees, along with the September 1, 2010 negotiated CBA increase, and an estimated increase for September 1, 2011. The revenue requirement also reflects the 2009 annualized pay increase for the other four Local Unions' employees, along with an estimated increase as of November 1, 2010 and November 1, 2011.

Q. PLEASE DESCRIBE THE 2010 AND 2011 INCREASE FOR NON-UNION EMPLOYEES OTHER THAN MANAGEMENT.

A. OTP had a 3 percent increase for non-union employees effective April 1, 2010. The 3 percent increase is cumulative and individual employee increases varied depending on performance, market data, and where an employee resides within their respective wage range. The revenue requirement reflects the 3 percent annualized increase (effective on April 1, 2010), to the 2009 wages for all non-union employees, along with an estimated increase of 3 percent for April 1, 2011. Non-union employees did not receive a general wage increase in 2009.

Q. PLEASE DESCRIBE THE 2010 INCREASE FOR MANAGEMENT EMPLOYEES.

A. The 3 percent increase for non-union wage increases, effective April 1, 2010, includes management employees. The 3 percent increase is cumulative and individual employee increases varied based on performance, market data, and where the employee resides within their respective wage range. A 2.4 percent increase for management employees was also included, effective April 1, 2010, along with an estimated increase of 3 percent for April 1, 2011. Management employees did not receive a general wage increase in 2009.

Q. HOW WAS THE OTP ANNUAL INCENTIVE PLAN COMPONENT OF THE REVENUE REQUIREMENT DETERMINED?

A. The OTP test year revenue requirement for the OTP KPA Plan was based on a 3 percent payout level, which is the 5-year average payout level for that plan for the years 2005 through 2009, as shown on attached as Exhibit__, (PEW-1) Schedule 3. The OTP test year revenue requirement also includes an amount for the OTP Management Plan that was based on the actual payout level for 2009, plus some carry-over from 2008, adjusted to remove any amounts over a 25 percent cap on individual employee incentives, which was based on 2009 compensation levels. The application of the 25 percent cap removed $233,488 of the 2009 payout (on a total company basis), plus all of the carryover from 2008.

Q. WHY SHOULD THESE COSTS OF THE OTP ANNUAL INCENTIVE PLAN BE INCLUDED IN THE REVENUE REQUIREMENT?

A. These costs of the OTP Annual Incentive Plan should be included in the revenue requirement for several reasons. The inclusion of annual incentive plans in total compensation packages is an established market practice and a necessary cost of doing business. As I have explained earlier in my direct testimony, the OTP Annual Incentive Plan includes an appropriate range and balance of factors that provide benefits to customers. Further, OTP's annual cash compensation levels, including the OTP Annual Incentive Plan, are below competitive market levels. When the 25 percent cap is applied, OTP's annual cash compensation levels are even further below competitive market levels.

The use of a 5-year average payout levels for the OTP KPA Plan is fairly representative of OTP's typical payout levels over time. The use of the 2009 actual level for the Management Plan, adjusted to remove any amounts over a 25 percent cap on individual employee incentives, is appropriate for determining OTP's revenue requirement because it is consistent with historic payout levels and has eliminated any amounts in excess of 25 percent of the management employees' 2009 salaries along with all carry-over from 2008.

Q. HOW DOES OTP'S PROPOSED TEST YEAR ANNUAL INCENTIVE COST COMPARE TO ACTUAL 2009 ANNUAL INCENTIVE LEVELS?

A. OTP's proposed KPA compensation cost is approximately $552,685 less than the actual payout level in 2009 (on a total company basis), which was the result of an overall 5 percent payout level in 2009. OTP's proposed OTP Management Plan compensation cost is approximately $233,488 less than the costs recognized in 2009 (on a total company basis). The difference represents payments to individuals that exceeded 25 percent of their base pay.

Q. PLEASE SUMMARIZE THE BASIS FOR OTP'S PROPOSED EMPLOYEE MEDICAL/DENTAL, PENSION, AND OPEB TEST YEAR EXPENSES.

A. OTP proposes that the test year expense levels for Employee Medical/Dental, Pension, and OPEB expenses (sometimes collectively "Benefit Expenses") be based on projected 2010 and 2011 expense levels.

Q. HOW DO OTP'S PROPOSED TEST YEAR EXPENSES FOR BENEFIT EXPENSES COMPARE TO ACTUAL 2009 LEVELS?

A. The proposed test year levels for Benefit Expenses are $5,539,365 higher than the 2009 expense levels, as shown in the following chart, which reflects total company costs for OTP:

	2009	2010	2011
Pension - FAS 87	$2,942,333	$5,973,476	$7,766,640
Medical & Dental	$10,030,336	$10,539,526	$11,510,543
Post Retirement Medical - FAS 106	$3,489,895	$4,197,150	$4,314,800
Long Term Disability - FAS 112	$145,652	$419,715	$328,300
TOTALS	$16,608,216	$21,129,867	$23,920,283

The primary drivers for increases between 2009 and the 2010 and 2011 actuarial estimates are related to pension benefits and medical benefits, for both active employees and retirees.

Q. PLEASE DESCRIBE THE SOURCES OF THE INCREASE IN PENSION COSTS.

A. Pension costs are expected to increase by $3,031,143 in 2010, and a total of $4,824,307 between 2009 actuals and the 2011 actuarial estimates. Two factors significantly impacted the Pension Plan. The first factor is the economic crisis of 2008, which led to dramatic decreases in global securities and capital markets in 2008. OTP Pension Plan asset values decreased from $178 million in October of 2007 to $109 million in February 2009. Although market conditions improved throughout the remainder of 2009, OTP's pension expenses (determined under FAS 87) were substantially increased by these market losses. Even though the market asset value is expected to increase in 2010, the expected return on assets is reduced because of asset smoothing under which the losses from 2008 will be recognized over a five-year period. Of the $3 million increase in 2010, approximately $2 million resulted from very substantial losses from 2008.

A second significant factor is the decline of the discount rate, or the interest rate, used to determine present value of future benefit obligations. The lower discount rate results in both an increased service cost and projected benefit obligation. For 2010, the lower discount rate resulted in an increase of approximately $1 million for the service costs.

Q. DID THE FUNDING REQUIREMENT UNDER THE PENSION PROTECTION ACT OF 2006 ("PPA") INCREASE THE FAS 87 EXPENSE LEVELS?

A. Funding requirements under the PPA are separate from the expense level determined under FAS 87. If the funding requirements under the PPA are higher than the FAS 87 pension expense levels that are recovered in rates, it is possible that shareholders may be required to provide the funds needed to cover some or all of the difference. If that occurs, there may be implications for the creation of a regulatory asset that increases rate base. While that may occur in the future, it has not occurred or been reflected in this case.

Q. HOW WAS OTP'S PROJECTED PENSION INCREASE FROM 2009 TO 2010 and 2011 DETERMINED?

A. The projected pension increase from 2009 to 2010 and 2011 was based on the actuarial determination of Pensions and OPEBs for 2009 that was prepared by Mercer. Our Pension and OPEB expenses are based on our demographics and standard actuarial assumptions, using and applying FAS 87 standards, along with the two key factors that I described.

Q. DOES MERCER REGULARLY PERFORM ACTUARIAL ANALYSES FOR OTP?

A. Yes. Mercer performs annual analyses of OTP's Pension and OPEB expenses. Annual actuarial analyses of Pension and OPEB obligations are performed to satisfy several legal requirements including: (i) ERISA, which requires annual actuarial reports regarding Pensions be filed with the Department of Labor; (ii) the Pension Benefits Guarantee Corporation, which also requires annual actuarial reports regarding Pension funding status; (iii) the Internal Revenue Service, which requires filing of an annual actuarial report as part of Form 5500; and (iv) the Securities Exchange Commission, which requires disclosure of actuarial analyses of Pensions and OPEBs in annual Form 10-K filings. These legal requirements underscore the fact that the Mercer actuarial analyses are reliable and independent assessments of anticipated Pension and OPEB expenses. The data relied on in this proceeding to estimate 2010 and 2011 Pension and OPEB expenses conforms to these standards.

Q. HOW DID MEDICAL COSTS AFFECT OTP'S OVERALL BENEFIT EXPENSES BETWEEN 2009 AND 2011?

A. Medical costs account for most of the remaining increases between 2009 and 2011, including most of the increases for Group Insurance costs for active employees ($1,480,207), Post Retirement Medical - FAS 106 costs ($824,905), and Long Term Disability - FAS 112 costs ($182,648). Medical costs continue to rise and remain a common challenge across the United States.

Q. HOW WERE THE INCREASES IN MEDICAL COSTS DETERMINED?

A. In 2009, we reviewed two sources for the 2010 active medical expense projections. In 2009, we changed from Lockton Companies to Mercer Health and Benefits Consulting "Mercer Health" for our active medical projections. The Lockton Companies projected a 7.77 percent increase while Mercer Health projected an increase of 7.0 percent. We are basing our request on the lower Mercer Health estimate. Mercer

Health generally utilizes 24 months of actual claims data, with a greater weighting, or emphasis placed on the most recent 12 months of actual claims data, along with a projected trend. Mercer Health determined that 2010 would generally reflect an 8.5 percent projected trend increase, which indicates that the 7.0 percent increase for OTP was less costly than the general trend in medical cost increases for 2010. For 2011 we projected a slightly higher increase, from the 2010 projections, of 10 percent, based on Mercer Health projections.

Q. WHY ARE HEALTH CARE COSTS PROJECTED TO INCREASE AT A GREATER AMOUNT IN 2011 THAN IN 2010?

A. The Patient Protection and Affordable Care Act of 2010 (“PPACA”) provided for certain requirements that will cause healthcare cost increases, beyond the anticipated medical trend rate of 8.5% projected by Mercer Health. In 2010, with PPACA changes to the Medicare retiree drug subsidy tax treatment, OTP was required to write-off a deferred tax asset of $2,519,466 (system-wide number). In 2011, as part of the PPACA, OTP will be required to change current health care plans in two ways: (i) children of employees are eligible for healthcare coverage until the age of 26; and (ii) there are no lifetime dollar limits. Although the actual impact will not be known until implemented, Mercer Health estimates plan costs to increase by ½ percent to 2 percent as a result of these two PPACA requirements. Coupled with an anticipated 8.5 percent trend increase, OTP believes a 10 percent increase to the health care plan to be reasonable for 2011.

Q. DOES OTP USE PROJECTIONS TO DETERMINE ITS ACTIVE MEDICAL COSTS?

A. Yes. OTP has utilized third parties to determine active medical costs for many years and has determined it to be an effective manner in which to project future active employee medical costs. Mercer Health provides very similar services and methodologies as Lockton Companies, and in this case a lower projection for 2010, so we see the projected active medical costs as reasonable and justified.

Q. HOW DOES THE PROJECTED INCREASE FOR 2010 AND 2011 COMPARE TO RECENT EXPERIENCE?

A. Increases for active medical through the past four years at OTP were 15 percent in 2007, 14 percent in 2008, 7 percent in 2009, and 7 percent in 2010. As noted earlier, Mercer Health used a medical trend of 8.5 percent for 2010, indicating an expectation that medical costs, in the absence of any company-specific variables, will increase by 8.5 percent in 2010. Mercer Health projected a 7 percent increase for the OTP plan in 2010 which indicates that the OTP plan is expected to increase at a rate lower than the general trend. OTP experienced higher-than-average medical costs in previous years, and much of that can be attributed to an aging workforce (with 40 percent of the OTP workforce being 50 years old or older). Considering our aging workforce, and the fact that there is a correlation between increased medical costs and age, we believe the 7 percent increase for 2010 and 10 percent increase for 2011 to be reasonable and fully justified.

Q. WHAT WAS THE BASIS OF OTP'S PROJECTED FAS 106 RETIREE MEDICAL AND FAS 112 LONG-TERM DISABILITY MEDICAL INCREASES FROM 2009 TO 2011?

A. As previously noted, Mercer provides the annual actuarial analysis for both FAS 106 and FAS 112. OTP is experiencing increases in both FAS 106 and FAS 112 in 2010 and 2011, and both are primarily related to aging demographics within our employee group, along with medical cost expectations.

VII. CONCLUSION

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. In order to attract and thereafter retain and motivate talented employees necessary to achieve our mission, OTP has structured a competitive total cash compensation and benefits package. As I have explained, this combination includes base salaries, active and post-retirement benefits, and incentive compensation. OTP's proposed compensation and benefit costs are reasonable, and should be included in rates.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

PETER E. WASBERG

EMPLOYMENT

2008 – PRESENT Otter Tail Power Company Fergus Falls, MN
Director, Human Resources & Safety

2004 – 2008 Otter Tail Power Company Fergus Falls, MN
Manager, Human Resources

2002 – 2004 Otter Tail Power Company Crookston, MN
Area Manager, Crookston & Bemidji

1997 – 2002 Otter Tail Power Company Hallock, MN
Division Manager, Hallock & Crookston Divisions Crookston, MN

1995 – 1997 Otter Tail Power Company Bemidji, MN
Office Manager, Bemidji Division

1991 – 1995 Otter Tail Power Company Milbank, SD
Division Accountant, Milbank Division

EDUCATION

- Executive and Organizational Development — The Levinson Institute
- Management Institute — University of Wisconsin – Madison
    - Coaching & Counseling
    - Full-Range Leadership
- Bachelor of Arts — Concordia College, Moorhead
    - Business Administration
    - Psychology

PROFESSIONAL AFFILIATIONS

- Society of Human Resources Management (SHRM) — Member
- University of Minnesota, Crookston — All-College Advisory Committee (Chair)
- Lake Region Halfway House — Director
- Crookston National Bank — Director

Summary Description of Otter Tail Power Pension Plans

Pension plan – Union Employees (does not apply to Coyote Union Employees)	
Type	Defined Benefit
Eligibility	Age 18 and date of hire
Benefit Accrual Service	1,000 hours service in a year
Formula	(.38(Final Average earnings) + .18(Final Average Earnings – Covered Compensation)) * (Years of service up to 30/30) + 1% for each year of service from 31 – 40 years
Final Average Earnings	Highest 2.5 year average of past 10 years
Covered Compensation	35 year average of SS taxable wage base ending in year prior to Normal Social Security Retirement Age
Vesting	Cliff: 100% after five years of Benefit Accrual Service
Normal retirement age	65
Early retirement age	Age 55 with at least 10 years of service
Early retirement reductions	Age 62 – 64: None Age 57 - 61: 5% per year prior to age 62 Age 55 - 56: 7% per year prior to age 57
Funding	Employer
Form of payment	50% J&S Annuity, 50%/75%/100% Survivor Annuity, 10-year Certain, Reversion Option
Pension Purchase Option	Roll-over portion of Retirement Savings Plan balance – buys additional annuity
Pre-retirement death benefits	Greater of Qualified Pre-retirement Death Benefit on date of death or 25% of pay

Summary Description of Otter Tail Power Pension Plans

Pension plan – Coyote Station Employees (hired before January 1, 2009)	
Type	Defined Benefit
Eligibility	Age 21 and date of hire
Benefit Accrual Service	1,000 hours service in a year
Formula	(.38(Final Average earnings) + .18(Final Average Earnings – Covered Compensation)) * (Years of service up to 30/30) + 1% for each year of service from 31 – 40 years
Final Average Earnings	Highest 3 year average of past 10 years
Covered Compensation	35 year average of SS taxable wage base ending in year prior to Normal Social Security Retirement Age
Vesting	Cliff: 100% after five years of Benefit Accrual Service
Normal retirement age	65
Early retirement age	Age 55 with at least 10 years of service
Early retirement reductions	Age 62 – 64: None Age 57 - 61: 5% per year prior to age 62 Age 55 - 56: 7% per year prior to age 57
Funding	Employer
Form of payment	50% J&S Annuity, 50%/75%/100% Survivor Annuity, 10-year Certain, Reversion Option
Pension Purchase Option	Roll-over portion of Retirement Savings Plan balance – buys additional annuity
Pre-retirement death benefits	Greater of Qualified Pre-retirement Death Benefit on date of death or 25% of pay

Summary Description of Otter Tail Power Pension Plans

Pension plan – Nonunion Employees (hired before September 1, 2006)	
Type	Defined Benefit
Eligibility	Age 18 and date of hire
Benefit Accrual Service	1,000 hours service in a year
Formula	(.38(Final Average earnings) + .18(Final Average Earnings – Covered Compensation)) * (Years of service up to 30/30) + 1% for each year of service from 31 – 40 years
Final Average Earnings	Highest 2.5 year average of past 10 years
Covered Compensation	35 year average of SS taxable wage base ending in year prior to Normal Social Security Retirement Age
Vesting	Cliff: 100% after five years of Benefit Accrual Service
Normal retirement age	65
Early retirement age	Age 55 with at least 10 years of service
Early retirement reductions	Age 62 – 64: None Age 57 - 61: 5% per year prior to age 62 Age 55 - 56: 7% per year prior to age 57
Funding	Employer
Form of payment	50% J&S Annuity, 50%/75%/100% Survivor Annuity, 10-year Certain, Reversion Option
Pension Purchase Option	Roll-over portion of Retirement Savings Plan balance – buys additional annuity
Pre-retirement death benefits	Greater of Qualified Pre-retirement Death Benefit on date of death or 25% of pay

5-YEAR PAYOUTS ON THE OTP KPA PLAN

5-year payouts on the OTP KPA Plan					
Year	**Eligible Earnings**	**Maximum**	**Max %**	**Actual**	**Actual %**
2005	$20,503,592	$1,230,216	6%	$881,654	4%
2006	$21,344,027	$1,280,642	6%	$213,440	1%
2007	$22,728,948	$1,363,737	6%	$340,934	1%
2008	$23,740,038	$1,424,402	6%	$356,101	2%
2009	$24,237,626	$1,454,258	6%	$1,211,881	5%
5Yr Avg.					3%