

**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

**IN THE MATTER OF THE APPLICATION)
OF ATMOS ENERGY CORPORATION) Docket No.
FOR REVIEW AND ADJUSTMENT OF ITS) 19-ATMG-525-RTS
NATURAL GAS RATES)**

REBUTTAL TESTIMONY OF JAMES F. REDA

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, EMPLOYER, AND BUSINESS ADDRESS

A. My name is James F. Reda. I am currently employed as the National Managing Director of Gallagher's Human Resources & Compensation Consulting and the service line leader for the executive compensation consulting practice. My business address is Arthur J. Gallagher & Co., 250 Park Avenue, 3rd Floor, New York, NY 10177.

Q. WHO DO YOU REPRESENT IN THIS CASE?

A. I am testifying on behalf of Atmos Energy Corporation ("Atmos Energy" or the "Company").

Q. PLEASE PROVIDE AN OVERVIEW OF YOUR PROFESSIONAL CREDENTIALS, INCLUDING YOUR EDUCATION AND OCCUPATIONAL BACKGROUND.

A. I am currently the National Managing Director of Gallagher's Human Resources & Compensation Consulting and the service line leader for the executive compensation consulting practice. I managed my own executive compensation consulting firm from 2004 to 2011 – James F. Reda & Associates LLC, which was

1 acquired by Arthur J. Gallagher & Co. in 2011. Prior to 2004, I worked at three
2 major executive compensation consulting firms, as well as a smaller boutique
3 executive compensation consulting firm. I hold a B.S. in Industrial Engineering
4 from Columbia University and an S.M. in Management from the Massachusetts
5 Institute of Technology, Sloan School of Management.

6 I have more than 32 years of experience specifically in the area of senior
7 executive compensation, and throughout my career have advised the compensation
8 committees of over 500 companies. I work with publicly-traded companies in
9 planning, creating, and implementing incentive programs. I also advise companies
10 on incentive strategy, including long- and short-term senior executive employment
11 arrangements, change-in-control metrics, business combinations, shareholder
12 rights, and corporate governance issues.

13 I am a member of the Society of Corporate Governance Professionals,
14 WorldatWork, The National Association of Stock Plan Professionals, National
15 Association of Corporate Directors, and the New York Society of Security
16 Analysts. I have written numerous articles on executive compensation, stock award
17 programs, long-term incentive strategy, merger and acquisition issues, and the role
18 of the compensation committees in publications such as The Corporate Board,
19 Directorship, Directors & Boards, Journal of Deferred Compensation,
20 WorldatWork Journal, Director's Monthly, Journal of Taxation of Employee
21 Benefits, and Journal of Compensation & Benefits. I have published books on
22 executive compensation, including Pay to Win: How America's Successful
23 Companies Pay Their Executives (Harcourt: 2000), and The Compensation

1 Committee Handbook (John Wiley: 2014), which is in its fourth edition.

2 **Q. WHAT OTHER TESTIMONY HAVE YOU PROVIDED IN RATE**
3 **MATTERS?**

4 A. I have previously provided testimony on behalf of Entergy Mississippi, Inc. and
5 Entergy New Orleans, Inc. to the regulatory authorities in the states of Mississippi
6 and Louisiana.

7 **II. SUMMARY OF TESTIMONY**

8 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

9 A. I will provide expert testimony with respect to the following matters:

- 10 • Reasonableness of total compensation levels for the executives, management,
11 and professional level employees compared to market practice;
- 12 • Appropriateness of Atmos Energy's annual and long-term incentive
13 compensation arrangements and their relevance for customers;
- 14 • A direct rebuttal to testimony provided by Ms. Kristina Luke Fry and
15 Andrea Crane regarding the incentive compensation plans of Atmos
16 Energy; and,
- 17 • My overall conclusions regarding the competitiveness of the Atmos Energy's
18 total compensation program and the inclusion of incentive compensation in
19 Atmos Energy's cost of service.

20 **Q. WHAT GENERAL CONCLUSIONS HAVE YOU REACHED IN**
21 **DEVELOPING YOUR TESTIMONY?**

22 A. Based upon my review of the Atmos Energy compensation program, I find the
23 Company's approach to remunerating and rewarding employees to be aligned with

1 competitive practice. Moreover, the Company demonstrates adherence to
2 compensation best practices, including targeting the 50th percentile of total direct
3 pay compared to companies of comparable size in their primary industry of natural
4 gas distribution. As a result, the program is comprehensive, fair, and equitable
5 to employees, and sensitive to the performance of the Company, its divisions,
6 and employees.

7 Beyond my own assessment, it is abundantly clear that Atmos Energy's
8 shareholders also agree with the reasonableness of its compensation plans and
9 programs. In 2018, 94 percent of Atmos Energy's shareholders approved the
10 Company's compensation structure. Companies with unfair compensation practices
11 that are divergent from the market simply do not receive approval at this high level.
12 This very positive "Say on Pay" vote clearly shows that the executive compensation
13 structure at Atmos Energy is reasonable and aligned with adding value to
14 shareholders and customers.

15 The Atmos Energy incentive programs are tied to achievement of financial
16 goals, a standard industry practice. Companies with strong financial performance
17 have a greater ability to fund programs that benefit customers compared to
18 companies that are financially distressed. The important relationship between
19 financial performance and customer benefit is clearly illustrated at Atmos Energy in
20 the following ways:

- 21 • Achievement of financial goals such as earnings per share plays a major
22 role in Atmos Energy's ability to allocate resources towards initiatives
23 that improve customer service. Atmos Energy's profitability over the

1 past seven years has allowed them to increase capital expenditure by
2 13%, which has greatly enhanced the process of modernizing
3 distribution and transmission systems to improve safety and reliability.

- 4 • A regression analysis conducted by Gallagher shows a positive
5 correlation between earnings per share and Atmos Energy's overall
6 customer satisfaction percentage for the years 2015-2019 (as determined
7 through the Company's annual telephonic survey which began in 2015).

8 As another example, my firm has conducted research of a company within
9 the broader utilities industry to determine the correlation between operational and
10 financial performance measures. This research plainly shows that to develop, build,
11 and maintain operational processes that benefit customers , adequate funding is
12 necessary. This level of funding is driven by company profitability and low cost of
13 capital, of which stock price growth is an important factor.

14 **III. OVERALL COMPENSATION PHILOSOPHY AND STRATEGY OF**
15 **ATMOS ENERGY**

16 **Q. PLEASE DESCRIBE THE OVERALL COMPENSATION**
17 **PHILOSOPHY AND STRATEGY OF ATMOS ENERGY.**

18 A. The Atmos Energy compensation program, applicable to executives and all
19 Company employees, is built around the principles and strategy of "Total
20 Rewards." Total Rewards was developed for all employees in 1998 and has
21 remained in effect for the past 20 years, subject to changes and enhancements
22 required to remain abreast of marketplace conditions. The guiding principles of
23 Total Rewards are: (1) payment of total cash compensation, including both base
24 salary and annual incentive awards; and (2) long-term incentive compensation

1 awards, all of which is targeted at the median (50th percentile) of such
2 compensation paid for equivalent positions at companies of comparable size in
3 the natural gas distribution industry. The inclusion of annual and long-term
4 incentive compensation emphasizes the Atmos Energy pay for performance
5 orientation. In addition, the Company focuses upon a fair and reasonable approach
6 to employee benefits, and the executive program limits the use of executive benefits
7 and perquisites.

8 **Q. WHAT IS THE TARGET STRATEGY (MARKET PERCENTILE) OF THE**
9 **ATMOS ENERGY DIRECT COMPENSATION PROGRAM?**

10 A. It is the intent of Atmos Energy to target all elements of direct compensation at the
11 median (50th percentile) of the competitive marketplace. Base salary, annual
12 incentive opportunities, and long-term incentive compensation are targeted to
13 provide 50th percentile competitive compensation opportunities for both executives
14 and employees. The 50th percentile strategy means that the Company wants to pay
15 at a point midway between the highest and lowest compensation rates of other
16 companies comprising the competitive benchmark. Stated another way, one-half
17 of the organizations competing with Atmos Energy for human resources talent will
18 pay more than Atmos Energy, while one-half of the organizations competing with
19 Atmos Energy will pay less than the Company.

20 **Q. DOES THE ATMOS ENERGY PROGRAM TARGET THE PAY FOR**
21 **EXECUTIVES DIFFERENTLY THAN IT DOES FOR ALL OTHER**
22 **EMPLOYEES?**

23 A. No, the executive compensation program is built around a 50th percentile market

1 strategy as is the program for the entire Atmos Energy employee population.
2 However, the Atmos Energy executive group will have more “pay at risk” since a
3 greater portion of their total compensation opportunity is variable and incentive
4 performance-based.

5 **Q. HOW DOES ATMOS ENERGY ESTABLISH PAY GRADES AND SALARY**
6 **RANGES THAT ARE COMPETITIVE?**

7 A. Atmos Energy has developed a base salary program that is externally competitive
8 based upon an assessment of marketplace 50th percentile competitive rates for base
9 salaries. The midpoint of the Company’s schedule of salary grades and ranges are
10 built around midpoints that replicate the 50th percentile of the competitive
11 marketplace. The Atmos Energy Human Resources department uses competitive
12 survey data from compensation surveys published and made available by such
13 sources as the American Gas Association, Towers Watson, Mercer, and Aon
14 Hewitt to match company jobs with benchmark jobs described in surveys to
15 assess the 50th percentile base salary rate. In turn, the competitive base
16 salary value results in the position being assigned to a pay grade and salary range
17 with a salary range midpoint approximating the competitive data 50th percentile
18 rate. Each salary range has an established minimum, midpoint, and maximum
19 salary rate. Annually, Atmos Energy receives an independent assessment from a
20 third party management consulting firm regarding the base salary program and its
21 overall competitiveness with respect to salary range movement and merit increase
22 budget.

23 Atmos Energy, like most organizations, uses compa-ratios to manage

1 individual salary rates. The compa-ratio is the percentage relationship between an
2 employee's salary and the midpoint of the respective salary range. Employees new
3 to the organization, or employees recently promoted to a new position with greater
4 responsibility and a higher salary grade, are expected to have lower compa-ratios
5 than fully seasoned employees who have had several years of experience and
6 satisfactory performance ratings in the same salary grade.

7 **IV. MARKET COMPETITIVENESS OF DIRECT COMPENSATION AND**
8 **EMPLOYEE BENEFITS PROVIDED BY ATMOS ENERGY TO ITS**
9 **EMPLOYEES AND EXECUTIVES**

10 **Q. PLEASE PROVIDE YOUR ASSESSMENT OF THE COMPETITIVENESS**
11 **OF THE ATMOS ENERGY EXECUTIVE COMPENSATION PROGRAM.**
12 **HOW DO ATMOS ENERGY EXECUTIVES RANK WITH THEIR**
13 **COUNTERPARTS IN OTHER LARGE GAS UTILITIES AND ENERGY**
14 **SERVICES COMPANIES?**

15 A. Atmos Energy executive compensation levels compare favorably with the
16 competitive market. I have reviewed two studies provided by an external executive
17 compensation consulting firm, Pay Governance LLC, to the Atmos Energy Board
18 of Directors Human Resources Committee in October 2018.

19 The first study covered the results of a market compensation analysis
20 comparing compensation for Atmos Energy's seven Management Committee
21 Officers against industry practice. The study compared Atmos Energy
22 compensation levels against Atmos Energy's approved peer group of thirteen gas
23 utility companies considered direct competitors for business and talent, as well as
24 from industry specific published survey data for utility and energy companies with
25 gas operations (Willis Towers Watson Data Services' American Gas Association

1 (AGA) Executive Compensation Survey). The study concluded that Atmos
2 Energy's total direct compensation levels, including incentives, were at or below
3 the 50th percentile when compared to both peer group and published survey data.

4 The second study covered the results of a very similar market compensation
5 analysis comparing compensation for Atmos Energy's seventeen Non-
6 Management Committee Officers against industry practice. The study compared
7 Atmos Energy compensation levels against industry specific published survey data
8 for utility and energy companies with gas operations (Willis Towers Watson Data
9 Services' American Gas Association (AGA) Executive Compensation Survey).
10 The study concluded that Atmos Energy's total direct compensation levels,
11 including incentives, were at or below the 50th percentile when compared to both
12 peer group and published survey data.

13 I believe it also important to note the results of the annual shareholder
14 advisory "Say-on-Pay" vote conducted by Atmos Energy. Like other large,
15 investor-owned companies, shareholders are asked to provide their view and
16 acceptance of the public company's executive compensation program. In 2018,
17 Atmos Energy received a favorable vote from 94 percent of the Company's
18 shareholders endorsing the Company's executive compensation program.
19 Companies with unfair compensation practices that are divergent from the
20 competitive market simply do not receive approval at this high level. This very
21 positive "Say on Pay" vote clearly shows that the executive compensation structure
22 at Atmos Energy is reasonable and competitive.
23

1 **V. PURPOSE OF THE ATMOS ENERGY INCENTIVE COMPENSATION**
2 **PLANS AND WHY SUCH INCENTIVE COMPENSATION SHOULD BE**
3 **INCLUDED IN THE COMPANY'S RATES**

4 **Q. PLEASE DESCRIBE THE ATMOS ENERGY INCENTIVE**
5 **COMPENSATION PLANS FOR EXECUTIVES.**

6 A. There are two incentive compensation plans which cover Atmos Energy executives.
7 The first plan is an annual incentive compensation plan, referred to as the
8 Management Incentive Plan (MIP). The MIP is a short-term incentive plan tied to
9 the Company's fiscal year with the payment of an annual cash bonus following the
10 completion of the fiscal year. There are an approximate 193 participants in the
11 MIP, including corporate officers, division presidents, directors, and certain
12 manager level employees in pay grades 7, 8, and 9. The performance measure for
13 funding awards under the MIP is earnings per share (EPS) over the performance
14 period compared to the Company's targeted EPS derived from the annual budgeting
15 process. Once funded, the actual award paid to the participant is subject to the
16 executive annual performance evaluation at which time the employee is
17 evaluated pursuant to numerous performance goals and objectives including
18 teamwork, adherence to safety and environmental concerns, customer retention and
19 satisfaction, divisional goals, and the like. The MIP is designed to comply with
20 Section 162(m) of the Internal Revenue Code as a performance-based plan. The
21 performance target for funding is established within the first 90 days of the fiscal
22 year by the Human Resources Committee (the plan's designated administrator), and
23 the same Committee certifies EPS results at the completion of the fiscal year to
24 calculate the amount of MIP award earned.

25 Individual awards may only be adjusted downward based upon the

1 assessment of other performance criteria noted above, as the Human Resources
2 Committee is only entitled to exercise negative discretion in adjusting the award of
3 a NEO. In addition, the Company has implemented another performance criterion
4 to the MIP, which is applicable only to the Atmos Energy Management Committee
5 members participating in the plan. This performance criterion requires that the
6 Company earn a positive Total Shareholder Return (TSR) during the fiscal year for
7 Management Committee executives to receive an award greater than target if EPS
8 results generate award levels above the targeted incentive opportunity.

9 Each participant in the plan has a target incentive percentage which is stated
10 as a percentage of the participant's eligible earnings from the fiscal year (generally
11 the employee's base salary earned in that fiscal year). Such target percentages
12 range from 20 percent to as high as 90 percent of the participant's base salary,
13 depending upon the importance and responsibility level of the position to the
14 organization. In other words, positions of higher responsibility level have a higher
15 percentage of their compensation at risk than those at a comparatively lower
16 responsibility level in the organization. If the Company achieves its target EPS
17 performance, and if the officer or key employee receives a fully satisfactory
18 performance evaluation for individual performance, the participant will earn his or
19 her target incentive award.

20 Another feature of the MIP is the participants' ability to convert earned MIP
21 awards to equity awards as a voluntary election. Participants may convert all or a
22 portion of their MIP incentive payments to time-lapse restricted stock units (RSUs)
23 with three-year vesting with a 20 percent value premium.

1 The second incentive plan which is applicable to Atmos Energy executives
2 and key management employees is the 1998 long-term incentive plan. In recent
3 years, the Atmos Energy long-term incentives have been granted in two primary
4 vehicles, each weighted at 50 percent of the award's fair value on the date of grant:
5 (1) three-year time lapse (Restricted Stock Units "RSUs") with cliff vesting
6 following three years of service; and (2) performance-based RSUs based upon the
7 attainment of a cumulative three-year EPS target prospectively. There are
8 approximately 193 Atmos Energy employees who receive long-term incentive
9 grants each year. Both forms of long-term incentives are granted in award values
10 linked to the Company's share price calculated at the time of grant, and the ultimate
11 value of both awards earned is tied directly to the Atmos Energy share price at the
12 date of lapse. The performance-based RSUs granted pursuant to the plan are
13 considered to be performance-based awards subject to Section 162(m). It should
14 be noted that the Company has not granted stock options to executives or
15 employees since 2005. The Company has not granted stock appreciation rights
16 (SARs), phantom stock, performance shares, performance units, or any other form
17 of long-term incentive compensation to its executive or key employees in its
18 recent history.

19 **Q. PLEASE DESCRIBE THE ATMOS ENERGY INCENTIVE**
20 **COMPENSATION PLANS APPLICABLE TO ALL OTHER EMPLOYEES.**

21 A. Atmos Energy has a single incentive compensation plan applicable to employees;
22 the plan is an annual incentive plan for all employees other than those 193
23 participants in the MIP. During the past year, approximately 4,370 employees

1 participated in this plan which is known as the Variable Pay Play (VPP). The VPP
2 provides award opportunities to participants to earn an annual cash incentive award
3 ranging in size equal to 52 percent to 15 percent of the employee's eligible annual
4 earnings based upon the same EPS targets used for the MIP plan. As with the MIP
5 and as a condition of payment for an award, a participant must receive a satisfactory
6 performance rating for individual performance and contributions to safety,
7 environment, and customer satisfaction concerns.

8 **Q. WHAT ADVANTAGES DO THE INCENTIVE COMPENSATION PLANS**
9 **BRING TO ATMOS ENERGY'S CUSTOMERS AND OTHER**
10 **STAKEHOLDERS?**

11 A. The MIP, VPP, and long-term performance-based plans benefit all stakeholders of
12 Atmos Energy: customers, shareholders, and employees. Variable incentive plans
13 such as these encourage top management to motivate, recognize, and reward
14 employee performance. Most important, such plans are only funded and paid if
15 performance warrants, thereby creating a variable expense that is directly
16 performance-based.

17 Further, the Atmos Energy incentive programs are tied to achievement of
18 financial goals that directly benefit customers. Companies with strong financial
19 performance have a greater ability to fund programs that benefit customers
20 compared to companies that are financially distressed. The important relationship
21 between financial performance and customer benefit is clearly illustrated at Atmos
22 Energy in the following ways:

- 23 • Achievement of financial goals such as earnings per share plays a major

1 role in Atmos Energy's ability to allocate resources towards initiatives
2 that improve customer service. Atmos Energy's profitability over the
3 over the past seven years has allowed them to increase capital
4 expenditure by 13%, which has greatly enhanced the process of
5 modernizing distribution and transmission systems to improve safety
6 and reliability.

- 7 • A regression analysis conducted by Gallagher shows a positive
8 correlation between earnings per share and Atmos Energy's overall
9 customer satisfaction percentage for the years 2015-2019 (as determined
10 through the Company's annual telephonic survey which began in 2015).

11 **Q. SHOULD THE COSTS RELATING TO ATMOS ENERGY**
12 **INCENTIVE COMPENSATION PLANS BE FULLY ALLOWED IN**
13 **RATES? WHY?**

14 A. Incentive compensation, including the full cost of the MIP, VPP, and long-term
15 incentive compensation plans, should be 100 percent included in the Atmos Energy
16 cost of service. Because the incentive plans create an incentive and motivation for
17 management and employees to excel in their performance of day to day operations,
18 and to achieve goals which are important to all customers, shareholders, and
19 Company employees, these expenses are no less recoverable in rates than base
20 salary. The cost of these incentive compensation plans is a regular element of the
21 Atmos Energy payroll expense. One of the factors this Commission considers
22 when determining whether the salaries paid by the utility are reasonable and
23 should, therefore, be included in rates is whether the total employee compensation

1 level (base pay plus incentive pay) is at the average market salary. As previously
2 mentioned, based upon my review, Atmos Energy's *total employee compensation*
3 *level* is at or slightly below the 50th percentile rate. Should only the base salary
4 portion of that total employee compensation level be recoverable, then the
5 Company would theoretically be incentivized not to place any part of its employee
6 compensation at risk. This would not be beneficial to customers, as it would
7 remove the financial incentive of leadership to perform at the highest level of
8 excellence.

9 In the alternative, if the incentive compensation portion of the employee's
10 compensation is universally disallowed simply because it is classified as incentive
11 compensation, then the Company would have to eliminate those costs, causing its
12 employee compensation to fall far below the average compensation rate. This
13 would result in a compensation level in rates that is clearly not reasonable and not
14 in conformance with the factor (average market compensation) considered by the
15 Commission to establish the level of employee compensation that should be
16 included in rates.

17 Further, the Atmos Energy incentive programs are tied to achievement of
18 financial goals that directly benefit customers. Companies with strong financial
19 performance have a greater ability to fund programs that benefit customers
20 compared to companies that are financially distressed. The important relationship
21 between financial performance and customer benefit is clearly illustrated at Atmos
22 Energy in the following ways:

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3 over the past seven years has allowed them to increase capital
4 expenditure by 13%, which has greatly enhanced the process of
5 modernizing distribution and transmission systems to improve safety
6 and reliability.

- 7 • A regression analysis conducted by Gallagher shows a positive
8 correlation between earnings per share and Atmos Energy's overall
9 customer satisfaction percentage for the years 2015-2019 (as determined
10 through the Company's annual telephonic survey which began in 2015).

11 **Q. DO OTHER GAS DISTRIBUTION UTILITY COMPANIES HAVE**
12 **INCENTIVE COMPENSATION PLANS LIKE THOSE OF ATMOS**
13 **ENERGY?**

14 A. The vast majority of investor-owned gas distribution public utilities have adopted
15 incentive compensation plans as an integral element of their compensation
16 programs. Annual incentive plans like the VPP and MIP have become prevalent
17 throughout the gas utility industry.

18 I have reviewed a memorandum provided by an external compensation
19 consulting firm, Willis Towers Watson, to Atmos Energy's Vice President of
20 Human Resources on October 31, 2016. Willis Towers Watson conducted a high
21 level review of Atmos Energy short-term incentive targets by pay level. The
22 memorandum included a comparison of Atmos Energy's incentive targets and
23 overall earnings per share (EPS) performance metric to those provided by other

1 utilities as reported in three survey sources: 2016 SGA Energy Compensation
2 Survey, 2016 American Gas Association Compensation Survey and 2016 CDB
3 Energy Services MMPS Compensation Survey.

4 The memorandum concluded that Atmos Energy was following market
5 practice by providing a short-term incentive (STI) incentive opportunity to all
6 employees, citing the following industry survey statistics:

- 7 • SGA reported 87% of participants provide a STI plan to non-union
8 employees, and over half of the participants (62%) made all employees
9 eligible.
- 10 • AGA reported that 80% of participants provide a STI plan to non-union
11 employees, and over half of the participants reported that all employees
12 are eligible.

13 The survey data outlined in the memorandum also indicated the most
14 common performance measures for determining incentive payouts, as well as the
15 most common metric used for incentive plan funding. SGA reported the most
16 common funding metric for incentive plans is earnings per share (EPS), the same
17 as used currently by Atmos Energy. By using EPS as the main determinant of
18 incentive payout for Atmos Energy employees, with some variation in payments
19 based on individual performance (employees receiving a “does not meet”
20 performance rating do not receive an award), Atmos Energy is reflective of external
21 market practice.

22 The competitive data demonstrates the broad use of incentive compensation
23 plans by gas utilities throughout the U.S. An important consideration in this matter

1 is that the fact that the companies surveyed report that they regularly extend
2 incentive compensation opportunities throughout the organization and that exempt,
3 non- management employees as well as non-exempt employees are regularly
4 participating in such plans like their management and executive counterparts.

5 **Q. WHAT SPECIAL ACTIONS HAS ATMOS ENERGY TAKEN TO MODIFY**
6 **ITS EXECUTIVE COMPENSATION PROGRAM IN RECENT YEARS TO**
7 **THE BENEFIT OF CUSTOMERS AND OTHER STAKEHOLDERS?**

8 A. Over the course of the past five years, Atmos Energy has amended or added to
9 features governing its executive compensation program that make the program
10 better aligned with Company performance, sensitive to the interests of
11 customers and shareholders, and more cost effective. Some of the enhancements
12 to the program include:

- 13 • Introduction of a clawback policy which provides for the recoupment
14 by the Company of any incentive compensation which may have
15 been paid due to misrepresentation, fraud, or erroneous financial
16 results;
- 17 • Elimination of payment by the Company of certain tax gross-up
18 payments which may become payable in the event of an imposed excise
19 tax attributed to an executive's termination following a change in
20 control transaction;
- 21 • The inclusion of additional performance measures for both MIP and
22 performance-based restricted stock units earned by members of the
23 Company's Management Committee;

- 1 • The addition of a policy specifically prohibiting any hedging
- 2 transactions in the Company's common stock by any employee;
- 3 • Beginning in 2010, the enforcement of the restriction period through the
- 4 end of the relevant three-year restriction period on all stock grants under
- 5 the long-term incentive plan for all recipients who have retired prior to
- 6 the expiration of such restricted period; and
- 7 • A substantial reduction in the value of time-lapse restricted stock units
- 8 or shares of bonus stock which may be paid as a premium to any
- 9 employee who elects to convert all or a portion of their incentive
- 10 payments pursuant to the MIP plan.

11 **VI. DIRECT REBUTTAL TO TESTIMONY PROVIDED BY MS. KRISTINA**
12 **LUKE FRY REGARDING THE INCENTIVE COMPENSATION PLANS**

13 **Q. HAVE YOU REVIEWED THE TESTIMONY OF MS. KRISTINA LUKE**
14 **FRY REGARDING INCENTIVE COMPENSATION? DO YOU AGREE**
15 **WITH HER CONCLUSIONS?**

16 A. I have reviewed Ms. Luke Fry's testimony regarding incentive compensation and
17 her conclusion that 100% of the Management Incentive Plan expenses, 50% of the
18 time lapse portion of the Long Term Incentive Plan expenses, and 100% of the
19 performance based award of the Long Term Incentive Plan expenses should be
20 eliminated from rates. I do not agree with her conclusions for reasons I have already
21 described and further described below.

22 There is a direct link between financial success and operational success,
23 which translates into better customer service. However, Ms. Luke Fry takes
24 particular issue with the incentive plans based on the Company's resulting EPS

1 rather than an operational metric that she believes benefits customers, stating that
2 “incenting employees to grow earnings per share benefits shareholders much more
3 directly than customers and may incent behavior that is detrimental or harmful to
4 customers over time.” The fact that customer satisfaction at Atmos Energy has
5 steadily increased over the past five years indicates a correlation between EPS and
6 operational excellence, which is clearly beneficial to Atmos Energy’s customers.

7 She further speculates that having incentive plan participants focusing on a
8 single financial measure like EPS could result in the “over-weighing” of a
9 participant's focus on the financial aspects of Atmos Energy's business compared
10 to operational aspects, stating that “this is a consequence of designing a plan which
11 causes participants to focus solely on financial performance measures instead of
12 concentrating on a broad range of financial and operational measures more likely
13 to benefit customers and shareholders alike.” Again, financial excellence such as
14 achieving aggressive EPS goals translates into higher corporate value and
15 operational excellence.

16 With regard to elimination of 50% of the Long Term Time Lapse Incentive
17 Plan (the portion that vests after three years of service), Ms. Luke Fry asserts that
18 “this assists in the retention of qualified executives and encourages executives to
19 perform in a way that is conducive to the long-term health and growth of the
20 Company. Customers and stockholders benefit when the Company maintains its
21 viability and grows over the long-term. Since both parties benefit, it is reasonable
22 for customers and stockholders to share in this portion of executive compensation.”
23 Ms. Luke Fry cites another rate case with a similar result, stating that “Atmos’

1 executive incentive compensation should be analyzed consistent with the decisions
2 in the 10-415 and 12-764 Dockets because the facts and circumstances of those rate
3 cases are essentially the same as those before the Commission in this docket.”

4 **Q. DO YOU AGREE IN TREATING LONG TERM TIME LAPSE INCENTIVE**
5 **PLAN DIFFERENTLY THAN PERFORMANCE BASED AWARD?**

6 A. No. They should be treated the same in that 100% of each type of LTI should be
7 included in the rate request. The reasoning is two-fold, which is as follows:

- 8 • There is a strong linkage between EPS performance and operational
9 excellence, as measured by customer satisfaction; and,
- 10 • Elimination of any amounts of LTI decreases recoverable compensation
11 from below median to substantially below median in the industry.

12 **Q. DO YOU AGREE WITH MS. LUKE FRY’S STATEMENTS ABOUT**
13 **FINANCIAL MEASURES AND LACK OF DIRECT BENEFIT TO**
14 **CUSTOMERS?**

15 A. I emphatically disagree with Ms. Luke Fry’s statements about financial
16 performance measures and the lack of direct benefit to customers. Ms. Luke Fry’s
17 misconceptions about the relationship between financial success and its benefit to
18 shareholders versus customers are embodied in her statement that “justness and
19 reasonableness favors requiring shareholders to pay more of the costs of these
20 programs than ratepayers. That is the result that is most balanced between Atmos’
21 shareholders and its ratepayers.”

22 Ms. Luke Fry’s testimony refers to the fact that in its two most recent Proxy
23 Statements, over 85 percent of Atmos Energy shareholders approved of the

1 compensation structure. Ms. Luke Fry completely misconstrues this fact to work in
2 the favor of her argument that shareholders are willing to pay for more of the
3 incentive costs than customers. She incorrectly attributes the favorable vote to
4 shareholder acceptance that incentive costs are their responsibility by stating that
5 “As a fully-regulated utility, Atmos’ shareholders are no doubt aware that the
6 decision to design and incentive compensation package in a way that aligns
7 employees’ interests with shareholders might come at the cost of being able to
8 recover those incentive compensation costs from ratepayers.”

9 Here, Ms. Luke Fry demonstrates a misunderstanding of what these Say on
10 Pay actually results tell us. These very positive “Say on Pay” votes (94 percent in
11 2018 and 85 percent in 2017) show that the executive compensation structure at
12 Atmos Energy is reasonable, fair, and aligned with adding value to shareholders and
13 customers. Atmos Energy’s shareholders recognize that executive total
14 compensation levels are very competitive.

15 Companies with unfair compensation practices that are divergent from the
16 market simply do not receive shareholder approval at this high level. Yet, Ms. Fry
17 somehow relates shareholder approval to customer exemption. In my opinion,
18 customers should take the high approval from Atmos Energy’s shareholders to mean
19 that the incentive compensation costs they are paying are reasonable and fair to
20 them. Based on my experience in this area, it is the alternative – shareholder
21 disapproval as exemplified by a low or failed Say on Pay vote – that might cause
22 customer concern. For example, shareholder disapproval would likely mean that
23 customers are being asked to pay incentive compensation costs that are unreasonable

1 from the perspective of being excessive and/or divergent from market norms.

2 In summary:

- 3 • Shareholder approval does not equate to willingness to pay all or more
4 of incentive costs, and there is no inverse relationship between these two
5 concepts. However, shareholder approval *does* equate to Atmos Energy
6 compensation being reasonable and fair.
- 7 • Companies can have excellent shareholder linkage and still have
8 excellent customer linkage – the two are by no means mutually
9 exclusive. In fact, shareholder approval should re-enforce customers in
10 that the incentive costs they are asked to pay are reasonable and fair.
11 Conversely, shareholder disapproval might understandably raise a “red
12 flag” for customers.

13 **Q. HOW DOES FINANCIAL SUCCESS BENEFIT CUSTOMERS? WHAT IS**
14 **MS. LUKE FRY MISSING?**

15 A. Based on my expertise and experience, positive financial performance is beneficial
16 to all of the Company’s stakeholders: customers, shareholders, and employees. My
17 opinions are based on the fact that companies with strong financial performance
18 have a greater ability to fund programs that benefit customers compared to
19 companies that are financially distressed.

20 A review of Atmos Energy’s most recently filed proxy statement makes it
21 very clear that the Company is allocating its resources towards systematically
22 improving customer service through advances in safety, reliability, and regulatory
23 mechanisms. Atmos Energy would not have the resources for such initiatives if the

1 company weren't profitable. Put simply, initiatives that improve customer service
2 require capital expenditure, and capital expenditure depends on profitability. The
3 Company's statements below made in their 2018 proxy filing illustrate the
4 important symbiotic relationships between capital expenditure, rate base increases,
5 and earnings per share.

- 6 • "Over the past seven years, our operating strategy has focused on
7 modernizing our distribution and transmission system to improve the
8 safety and reliability of this system. Since that time, our capital
9 expenditures have increased approximately 13% annually. In addition,
10 during this same period, we have added new or modified existing
11 regulatory mechanisms to reduce regulatory lag. Our ability to increase
12 capital spending each year to modernize our system has increased our
13 rate base, which has also resulted in increasing earnings per share during
14 this same period."

- 15 • "Capital expenditures for fiscal 2018 totaled approximately \$1.47
16 billion, with approximately 85 percent of this amount invested to
17 improve the safety and reliability of our distribution and transmission
18 systems, and with a significant portion of this investment incurred under
19 regulatory mechanisms. Total spending during fiscal 2017 and 2018
20 under these and other mechanisms enabled the Company to implement
21 a total of 18 regulatory filings during fiscal 2018 that should increase
22 annual operating income over the near term by approximately \$80
23 million. We funded our fiscal 2018 capital expenditures program

1 primarily through operating cash flows of about \$1.125 billion.”

2 The relationship between financial performance and benefit to customers is
3 further supported when looking at Atmos Energy’s overall customer satisfaction
4 percentage for the years 2015-2019 as determined through the Company’s annual
5 telephonic customer satisfaction survey which began in 2015. A regression analysis
6 conducted by Gallagher shows a clear link between Atmos Energy’s overall
7 customer satisfaction percentage and positive financial performance as measured
8 by various metrics including EPS.

9 For each year in the survey period (2015-2019), we compared the customer
10 satisfaction percentage to the Company’s financial results as measured by
11 performance metrics for two years prior. For example, the overall customer
12 satisfaction percentage for 2019 was compared to financial performance measures
13 for 2017. We used a two year “lag” in the financial performance variable to adjust
14 for the time it might take for financial performance to spur the implementation of
15 changes that affect customer satisfaction.

16 Based on the results of this analysis, various performance measures,
17 including Operating Income, Net Income, Diluted EPS, Basic EPS and Basic EPS
18 Excluding Extraordinary Items, are positively correlated to customer satisfaction.
19 See **Appendix A** for graphs showing the relationship between customer satisfaction
20 and Diluted EPS, which is the measure most aligned with Atmos Energy’s incentive
21 design.

22 As another example, Gallagher has previously conducted research to
23 determine the correlation between operational and financial performance measures

1 at electric utilities, which due to the nature of their business have service
2 interruption operational metrics that lend themselves more easily to statistical
3 analysis than those in the natural gas industry. This research plainly shows that to
4 develop, build, and maintain operational processes that benefit customers, adequate
5 funding is necessary. This level of funding is driven by company profitability and
6 low cost of capital, of which stock price growth is an important factor.

7 Using thirteen years of historical data on electric service interruptions
8 (System Average Interruption Frequency Index or “SAIFI”), we found that stock
9 price and profit-related measures like net income, EBTIDA (earnings before taxes,
10 interest, depreciation, and amortization), and cash flow are correlated with SAIFI
11 improvement. This means that higher profit, cash flow, or stock price levels are
12 related to lower service interruptions. Accordingly, this implies that healthy,
13 increasing profitability, cash flow and stock prices are factors in improving
14 operational effectiveness. See **Appendix B** for more details.

15 **Q. WHY ARE INCENTIVE PLANS IMPORTANT AND NECESSARY FOR**
16 **ATMOS ENERGY TO ATTRACT, RETAIN, AND MOTIVATE TOP**
17 **TALENT?**

18 A. Ms. Luke Fry’s analysis does not recognize the necessity of these incentive plans
19 for attracting, retaining, and motivating top talent. As shown earlier in this
20 testimony, Atmos Energy employs incentive compensation plans that are
21 comparable to other gas utility organizations with which it competes for executive
22 talent. Those companies use incentive compensation programs to reward and retain
23 their top management, and Atmos Energy must do the same in order to compete.

1 Moreover, the reports prepared by the Company's external compensation
2 consultant in October of 2018 clearly show that Atmos Energy's executive total
3 compensation levels were at or below the 50th percentile when compared to both
4 industry peer group and industry published survey data. If the incentive
5 compensation portion of the compensation is arbitrarily disallowed simply because
6 it is classified as incentive compensation, then the cost of executive compensation
7 included in rates would fall below significantly below the 50th percentile
8 compensation rate. Over the long term, it is unsustainable to provide compensation
9 at levels not recoverable in rates. Paying below market rates could significantly
10 affect Atmos Energy's ability to retain and attract experienced and effective key
11 leaders, which could in turn decrease profitability. As stated earlier, profitability is
12 what has allowed Atmos Energy to fund resources that directly benefit customers.

13 **Q. HAVE YOU REVIEWED THE TESTIMONY OF CITIZENS UTILITY**
14 **RATEPAYERS BOARD ("CURB") WITNESS ANDREA CRANE?**

15 A. Yes.

16 **Q. DO YOU AGREE WITH THE ARGUMENTS AND RECOMMENDATIONS**
17 **OF WITNESS CRANE REGARDING ATMOS ENERGY'S INCENTIVE**
18 **COMPENSATION?**

19 A. No. Witness Crane's arguments are based upon similar incorrect premises, and for
20 the reasons stated herein, her recommendations should therefore be rejected as well.

1 **VII. OVERALL CONCLUSIONS REGARDING THE COMPETITIVENESS OF**
2 **THE ATMOS ENERGY TOTAL COMPENSATION PROGRAM AND THE**
3 **INCLUSION OF INCENTIVE COMPENSATION IN THE ATMOS**
4 **ENERGY COST OF SERVICE**

5 **Q. WHAT IS YOUR OVERALL ASSESSMENT OF THE ATMOS ENERGY**
6 **TOTAL COMPENSATION PROGRAM FOR EXECUTIVES AND**
7 **EMPLOYEES?**

8 A. It is my overall assessment conclusion that the Atmos Energy total compensation
9 program is based upon competitive standards and benchmarks that are reasonable
10 and fair to all constituencies: customers, shareholders, and employees.

11 I have reached this conclusion with specific consideration of:

- 12 • The Atmos Energy direct compensation program, including base
13 salary and incentive compensation plans, are targeted to provide
14 pay levels at the 50th percentile of the marketplace based upon
15 legitimate and realistic benchmarks of competitive market conditions;
- 16 • Actual direct pay levels are delivered at the 50th percentile of the
17 marketplace, depending upon performance;
- 18 • Incentive compensation plans tied to financial performance are
19 beneficial to all of the Company's stakeholders: customers,
20 shareholders, and employees.

21 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

22 A. Yes.

VERIFICATION

STATE OF New York

)

)

COUNTY OF Westchester

)

James F. Reda, being duly sworn upon his oath, deposes and states that he is Managing Director with Gallagher Human Resources & Compensation Consulting; that he has read and is familiar with the foregoing Rebuttal Testimony filed herewith; and that the statements made therein are true to the best of his knowledge, information and belief.



James F. Reda

Subscribed and sworn before me this 12th day of November, 2019.

LINDA LANGER
Notary Public-State of New York
No. 01-LA6057457
Qualified in Westchester County
My Commission Expires 4-16-2023

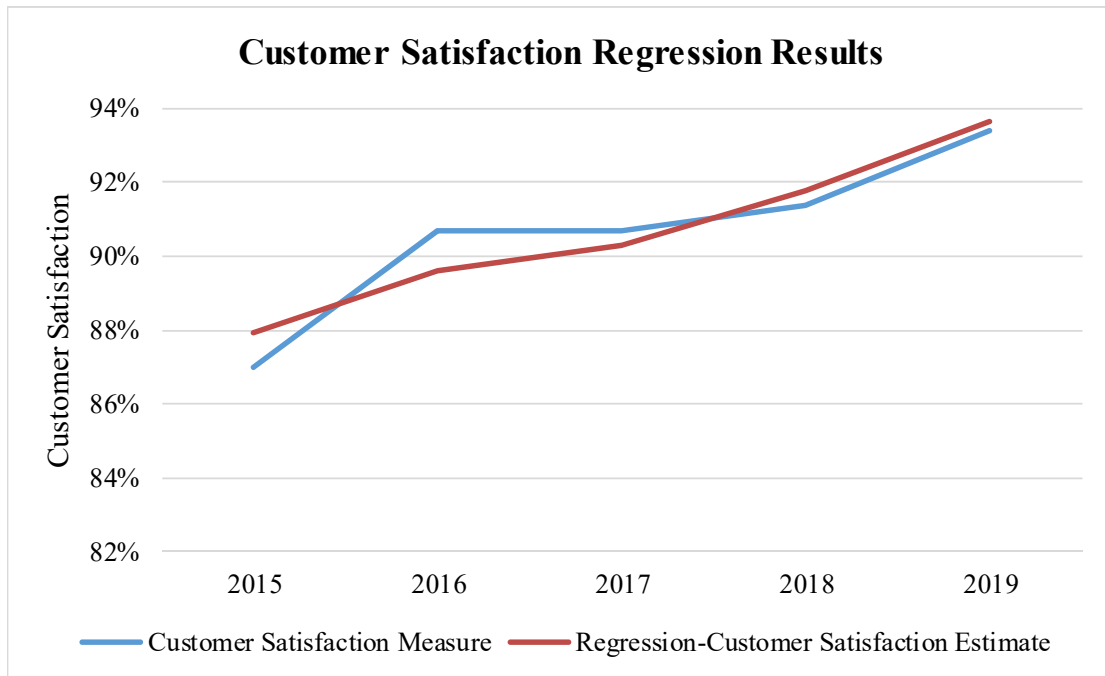
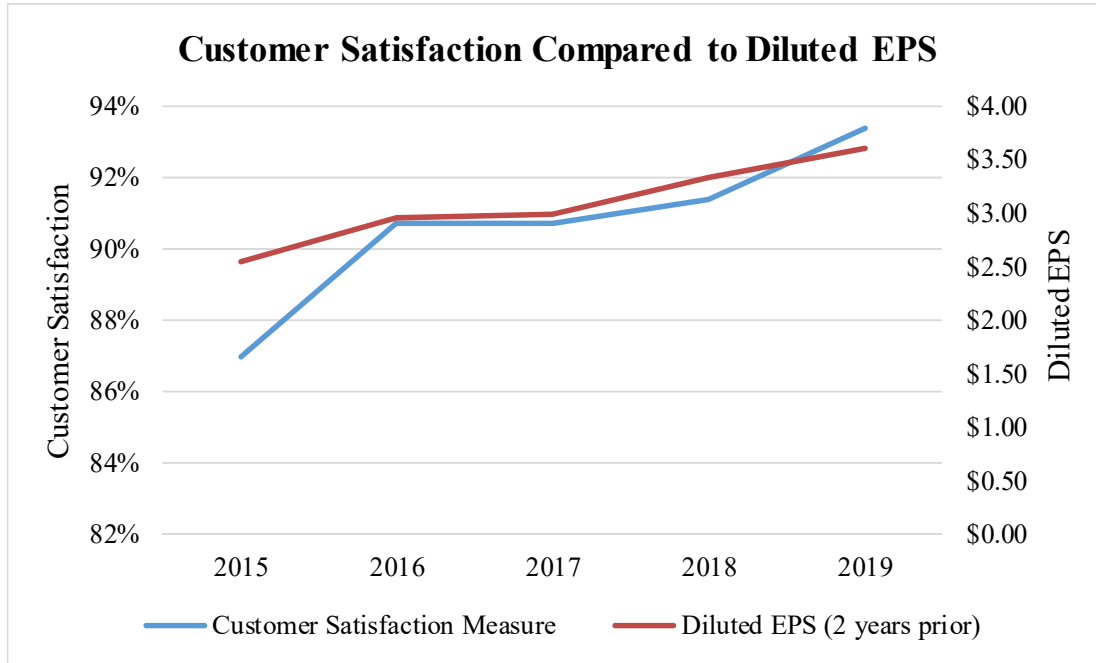
Notary Public

My appointment expires: 4/16/23

APPENDIX A

CORRELATION BETWEEN ATMOS ENERGY'S CUSTOMER SATISFACTION & FINANCIAL PERFORMANCE

A regression analysis conducted by Gallagher shows a clear link between Atmos Energy's overall customer satisfaction percentage as measured by the Company's annual survey and positive financial performance as measured by various metrics for two years prior, including Diluted EPS.



APPENDIX B

CORRELATION BETWEEN OPERATIONAL & FINANCIAL PERFORMANCE MEASURES – BROADER UTILITIES INDUSTRY

Gallagher analysis shows that to develop, build, and maintain operational processes that benefit customers, adequate funding is necessary. This level of funding is driven by company profitability and low cost of capital, of which stock price growth is an important factor. This analysis was conducted for a company within Atmos Energy's broader utilities industry.

Using thirteen years of historical data on service interruptions (SAIFI), we found that stock price and profit-related measures like net income, EBTIDA (earnings before taxes, interest, depreciation, and amortization), and cash flow are correlated with SAIFI improvement. This means that higher profit, cash flow, or stock price levels are related to lower service interruptions. Accordingly, this implies that healthy, increasing profitability, cash flow and stock prices are factors in improving operational effectiveness.

We found that cash flow (which is one of the two financial measures used in the annual incentive plan) had the closest correlation to SAIFI. In analyzing the relationship between cash flow and stock price with SAIFI, historical cash flow and the average annual stock prices were inflation-adjusted using the GDP implicit price deflator ("Real Cash Flow" and "Real Average Stock Price"). EMI SAIFI also has a high negative correlation with cash flow.

-67% Correlation Coefficient/44% Adjusted R-Squared

SAIFI vs Real Cash Flow

