



Burlington Hydro Inc.

Incentive Program Review

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Draft for Discussion

Executive Summary

- Burlington Hydro Inc. (“Burlington Hydro”) has asked Willis Towers Watson to review its annual incentive program against competitive market practice and its business strategy and objectives. Below we outline several key changes for consideration

1. Reduce Number of Corporate Measures

- While the current scorecard approach is aligned with prevalent market practice, having a significant number of measures results in less pay differentiation year over year
- The incentive should focus on the most important priorities of the organization (e.g., sustain EBIT, reliability, and customer service), rather than try to measure all the areas of the business

2. Reduce Number of Individual Measures

- [REDACTED]
- To provide focus and align closely with the strategic plan, [REDACTED] individual performance metrics should be restricted to three key strategic priorities the Board sees as the most important.
 - The metrics may be measured using discretion, but expected and threshold results should be clearly communicated and understood

3. Setting Performance Targets and Ranges

- Some targets (e.g., OEB targets) have not changed for a number of years and others change annually
- The Board should review the targets and performance range relative to the business plan as well as historical performance (e.g., 3 to 5 years) to ensure the targets have sufficient stretch

Executive Summary

4. Ensure Maximum is Competitive with Market Maximum (Leverage / Payout Range)

[Note: Willis Towers Watson was not asked to review the competitiveness of pay levels]

- If Burlington Hydro's maximum total cash (salary + maximum incentive) is competitive with target total cash (salary + target incentive) in the market, then the overall cash opportunity provided by Burlington Hydro is below market
 - e.g., Burlington Hydro's maximum opportunity is 20% of salary, whereas in the market the target opportunity is 20% of salary with the upside potential to earn 30% of salary for maximum performance
- Consideration could be given to recalibrating Burlington Hydro's maximum award with the market maximum and reset expectations around award payouts (to be around target)
- However, the challenge will be in transitioning from the current plan and performance expectations and this transition may need to occur over time

Introduction and Background

- Burlington Hydro Inc. (“Burlington Hydro”) has asked Willis Towers Watson to review its annual incentive program against competitive market practice and its business strategy and objectives
 - Burlington Hydro is solely owned by the City of Burlington and consists of distribution operations (i.e., no generation operations)
- As part of the process, we discussed the Board’s perceptions of the plan with the Darla Youldon (Chair) and Jennifer Smith (VP Corporate Relations)
- Competitive market practices referenced are based on our consulting experience within the industry and Utility Industry participants in Willis Towers Watson’s 2015 Global Executive Incentive Design Survey

Summary of Interview Findings

- Overall the Board is satisfied with the incentive scorecard approach; however, some adjustments may need to occur
 - Review target and range setting of performance measures as Burlington Hydro has consistently exceeded targets in recent years
 - Reconsider the type and / or reduce the number of individual performance measures [REDACTED]
- Strategic and pay decisions of the Board are subject to review and commentary by the City

Funding, Eligibility and Payout Range

Design Element	Burlington Hydro	Market Practice
Plan Funding	<ul style="list-style-type: none"> “Sum of targets” approach (target incentives of all eligible participants are added and the total amount is budgeted) Amounts are recovered through the rate base 	<ul style="list-style-type: none"> The “sum of targets” approach is the most prevalent funding approach in the industry (48%) The majority of utilities (67%) recover all or a portion of the annual incentive through the rate base
Eligibility & Incentive Opportunity	<ul style="list-style-type: none"> All non-unionized employees, including management, are eligible to participate in the plan Target incentive levels increase with role scope / size (see below) 	<ul style="list-style-type: none"> Broad-based annual incentive plans are typical among utility organizations Burlington Hydro’s incentive maximum opportunities are consistent with target incentive opportunities found in the market
Payout Range (Leverage)	<ul style="list-style-type: none"> Target payout is equal to maximum Threshold is equal to 33% of maximum 	<ul style="list-style-type: none"> Typically ranges from 0.5x to 1.5x target, with target payout equivalent to budgeted performance <ul style="list-style-type: none"> Public utilities tend to have narrower ranges than private utilities which can pay up to 2x target for maximum performance

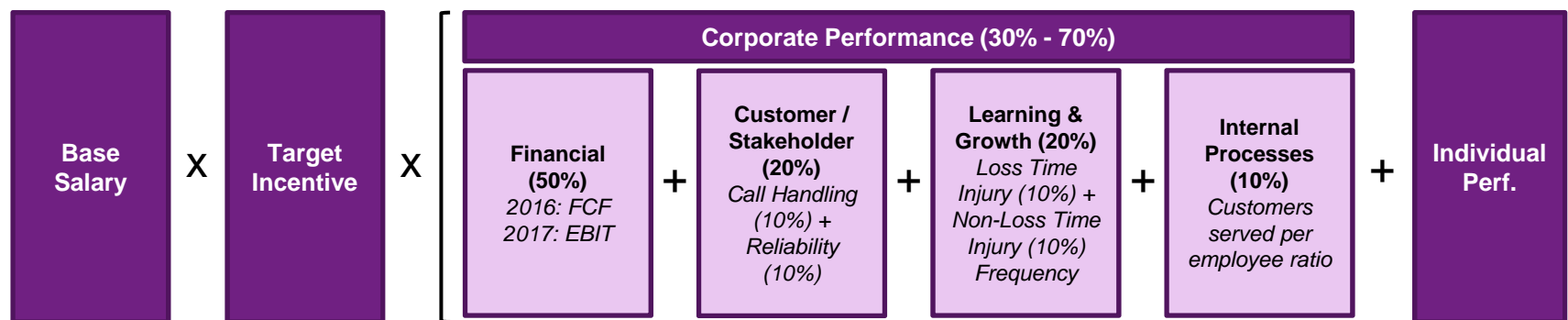
Level	Target Incentive (% of Salary)	Max Incentive (% of Salary)	Incentive Mix	
			Corporate Performance	Individual Performance
■	■	■	70%	30%
■	■	■	60%	40%
■	■	■	50%	50%
■	■	■	40%	60%
■	■	■	30%	70%
■	■	■	30%	70%

Performance Measures

Performance Measures & Weighting

Design Element	Burlington Hydro	Market Practice
Approach / Formula	<ul style="list-style-type: none"> Scorecard of 6 corporate measures + individual performance 	<ul style="list-style-type: none"> Annual incentive scorecards with 4 or more measures are common (72%) among utility organizations
Performance Measures & Weighting	<ul style="list-style-type: none"> A combination of corporate financial and operational measures and individual performance <ul style="list-style-type: none"> Corporate performance measures include earnings before interest and tax (EBIT, starting in 2017), call handling, reliability, safety, and number of customers served per employee ratio Individual performance measures can be up to 5 measures Relative weighting of corporate vs. individual performance measures vary by level 	<ul style="list-style-type: none"> Bottom line pre-tax measures (e.g., EBIT) are the most prevalent (50%) followed by cash flow (32%) and bottom line measures Most utilities include non-financial measures including safety and environment measures and individual performance

Illustrative Calculation of Actual Incentive Payout with Component Weighting:

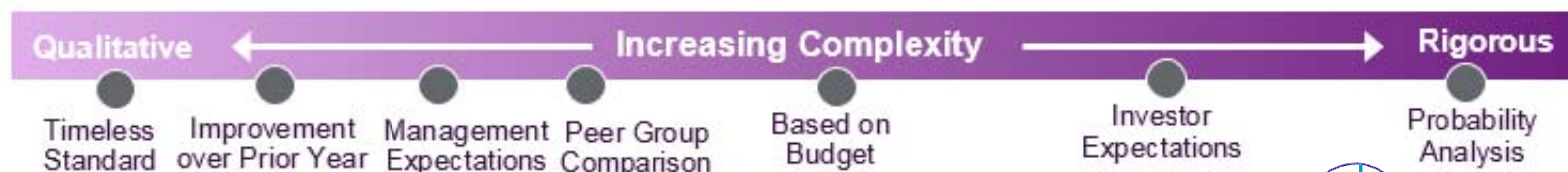


Performance Measures

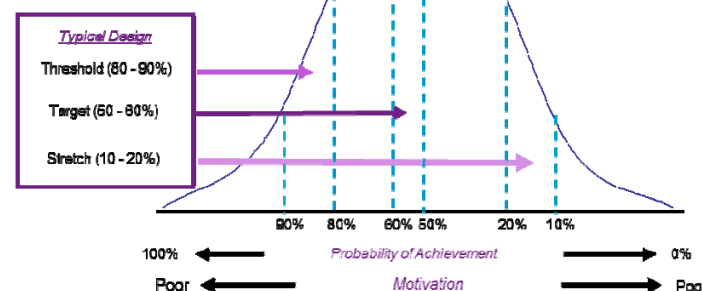
Corporate Performance Target Setting and Ranges

Design Element	Burlington Hydro
Performance Target and Range	<ul style="list-style-type: none"> It appears as though target performance are aligned with maximum payout awards Performance between threshold and maximum appears to be “stepped” (rather than interpolated)

- Most companies set variable pay performance targets based on internal budgets
 - Budgets are often the product of internal negotiation (v. rigorous analysis) and may lead to payouts misaligned with market-typical performance or company’s historical results
- Effective targets can vary from budget and are set considering a variety of factors and analyses



- It is common to establish performance targets with the following “rules of thumb”:
 - 80% - 90% of the time - above threshold performance
 - 50% - 60% of the time - at or around target performance
 - 10% - 20% of the time - at or above maximum performance



Performance Measures

Corporate Performance Target Setting and Ranges

- An analysis of actual performance over the past 5 years relative to budget indicates that Burlington Hydro has consistently outperformed the budgeted max performance

Category	Performance Measure	Weighting	Actual Performance (Budgeted Max Performance)					5 Year Average Performance
			2011	2012	2013	2014	2015	
Financial	Free Cash Flow (in millions)	50%	\$3.74	\$0.80	\$0.99	\$2.86	\$2.62	\$2.20
			\$2.76	-\$2.95	\$0.48	\$2.39	\$1.48	\$0.83
	% +/- Budget		36%	-	106%	20%	77%	165%
Customer / Stakeholder	OEB Objective - Call Handling	10%	69.0%	77.0%	75.0%	76.0%	75.8%	74.6%
			65.0%	75.0%	75.0%	75.0%	75.0%	73.0%
	% +/- Budget		6%	3%	0%	1%	1%	2%
	OEB Objective - Reliability	10%	+11%	+12%	+22%	+22%	+22%	+18%
			+10%	+10%	+10%	+10%	+10%	+10%
	% +/- Budget		10%	20%	120%	120%	120%	78%
Safety	BHI Loss Time Injury (LTI) Frequency	10%	1.20	1.19	1.19	1.67	1.18	1.29
			0.50	0.50	0.50	0.50	0.50	0.50
	% +/- Budget		140%	138%	138%	234%	136%	157%
	BHI Non-Loss Time Injury (LTI) Frequency	10%	2.15	2.39	2.62	2.62	2.36	2.43
			3.00	3.00	3.00	3.00	3.00	3.00
	% +/- Budget		-28%	-20%	-13%	-13%	-21%	-19%
Operational / Internal	Customers Served Per Employee Ratio	10%	677	677	687	691	688	684
			670	670	670	670	670	670
	% +/- Budget		1%	1%	3%	3%	3%	2%
Overall Performance (payout vs. maximum)			90.60%	94.60%	94.60%	90%	94.60%	

Performance Measures

EBIT Target Setting and Ranges

- If Burlington Hydro considers creating a performance and payout range around target (budget), consideration could be given to using probability analysis to determine the appropriate performance range (see high-level findings of an initial analysis based on historical performance below)
 - However, in addition, threshold should be set considering the bank, debt, and shareholder obligations
 - Maximum performance should consider at what level of performance does the risk of achieving the performance outweigh the value brought to the organization

Performance Levels	EBIT Performance Ranges (based on <u>budgeted</u> 5 year performance)	EBIT Performance Range (based on <u>actual</u> 5 year performance)
Threshold Performance	4.3 <i>80% Probability of Attainment</i>	5.3 <i>80% Probability of Attainment</i>
Target Performance	5.6 <i>50% Probability of Attainment</i>	6.5 <i>50% Probability of Attainment</i>
Maximum Performance	7.7 <i>10% Probability of Attainment</i>	8.2 <i>10% Probability of Attainment</i>

Performance Measures

Individual Performance Measures

Design Element	Burlington Hydro	Market Practice
Individual Performance	<ul style="list-style-type: none"> Weighted component with multiple objectives aligned with the business strategy [REDACTED] Weighting (v. corporate measures) varies by level 	<ul style="list-style-type: none"> Measuring individual performance is common within Utility organizations; typically restricted to 3 – 5 measures for clarity and resonance Weighting tends to be higher in public utilities (e.g., up to 40%) than in private utilities (typically 20% - 25%) Allows the Board to make a qualitative assessment of performance and reward employees for the right behaviours, even if they are not manifested in the results

Category	Goal / Objective	Weighting
Revenue Security	Burlington Hydro's 2015 IRM rate application (7.5% weighting) Shared services model (GSC / City of Burlington) (7.5% weighting)	15%
Learning and Growth	Negotiations: Lead the development of a comprehensive negotiations strategy with the intent to a fair CBA in 2017 (10% weighting) Employee satisfaction and productivity (5% weighting)	15%
Brand / Reputation Development	Develop and execute a communications strategy to promote Burlington Hydro as a valuable contributor to the success of the City of Burlington; raise brand equity; respond effectively to stakeholder needs	10%
Financial Viability	Provide the shareholder (City of Burlington) with a steady income stream - interest and dividends	20%
Risk Management	Introduce a risk management program at Board level and in the Corporation	10%
Strategic Direction (BES)	Grow the non-regulated revenue stream to support future shareholder value and offset potential decreases in regulated revenues Stretch target: Acquiring new line of business while maintaining employee retention and EBITDA levels	20% (+5% stretch target)
Safety Excellence	Enhance Burlington Hydro's Health and Safety program to avoid lost time and equipment damage	10%

Plan Governance

Circuit Breaker, Discretion, and Process

Design Element	Burlington Hydro	Market Practice
Circuit Breaker	<ul style="list-style-type: none"> No payouts will be made if there is impact to forecasted shareholder dividends 	<ul style="list-style-type: none"> Circuit breakers (threshold performance override below which no incentives are paid) are included in the majority of Utility plans (59%) Typically is a financial measure (e.g., EBIT)
Discretion	<ul style="list-style-type: none"> Positive discretion may be made for special awards that Burlington Hydro receives or for exceptional performance on specific financial metrics (i.e., customer satisfaction, safety, ROE, EBIT, net income, capital expenditures / costs) 	<ul style="list-style-type: none"> The ability to use discretion to adjust awards based on a holistic evaluation of performance or for unusual circumstances is relatively common However, discretion is rarely used (12%) and is typically used “downwards” (75% of companies that used discretion)
Clawback / Recoupment	<ul style="list-style-type: none"> No recoupment policy (whereby the award may be required to be paid back if the financials are materially restated) 	<ul style="list-style-type: none"> 45% have a Clawback policy to recoup awards due to misconduct or financial restatement
Annual Review Process	<ol style="list-style-type: none"> Financial statements are reviewed and approved by the Audit and Governance Committee Corporate results are reviewed by staff against financial statements ██████ individual goals are reviewed Payouts are calculated based on total results 	<ul style="list-style-type: none"> Burlington Hydro's process follows typical processes observed in the competitive market Most organizations pay incentives after the annual and financial statements are approved Consideration could be given to calibrating individual goals and stretch targets to ensure that there is pay for performance alignment (notably for exceptional performance)