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Witness:	David Cross
Sponsoring Party:	Mercer Human Resource Consulting
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EC-2002-1

REBUTTAL TESTIMONY

OF

DAVID CROSS

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

Exhibit No. 151 P
Date 7/10/02 Case No. EC-2002-1
Reporter KRM

** **DENOTES PROPRIETARY INFORMATION** **

St. Louis, Missouri
May, 2002

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REBUTTAL TESTIMONY

OF

DAVID CROSS

CASE NO. EC-2002-1

Q. Please state your name and business address.

A. My name is David Cross. My business address is 1717 Arch Street, 27th Floor; Philadelphia, PA 19103.

Q. By whom and in what capacity are you employed?

A. I am employed by Mercer Human Resource Consulting as Principal and Senior Consultant.

Q. Please describe your education.

A. I completed graduate course work in Political Economy at the University of Maryland and have a Bachelor's Degree in Political Science from Cleveland State University.

Q. Please describe your background in compensation.

A. I am a Principal and Senior Consultant with Mercer and lead the Reward and Talent Management practice in our Princeton/Philadelphia office. I have been with Mercer for four years. While I have clients across a wide spectrum of industries, I have an industry specialty working with utilities and energy service organizations, like Ameren. Prior to joining Mercer, I worked with a similar client base as a senior level consultant with Towers Perrin for five years. Towers Perrin is a competitor firm with a similar client profile to Mercer. The foundation of my utility expertise came through my experience prior to Towers Perrin when I worked for the Edison Electric Institute (EEI) for six years. As the Manager of Human Resource Information for EEI, I managed and/or developed annual industry-wide compensation surveys including Executive Compensation, the Management Administrative & Professional (MAP) Survey, the Non-Exempt Wage Survey, and the Collective Bargaining Survey. Some of the utility clients for whom I have conducted compensation projects include Potomac Electric Power Company, Arizona Public Service, Cinergy, Knoxville Utilities Board, Kansas City Power & Light and Omaha Public Power District.

Q. Please provide a summary of your testimony.

A. My testimony addresses the appropriateness of the design, competitiveness, and payment of AmerenUE's incentive compensation plans compared to industry practices. I first cover the general standards of incentive design, then analyze how Ameren's plans compare to other plans across the utility industry. The primary objectives of an incentive plan are to attract, retain and motivate employees. In designing an incentive plan one should align two factors: 1) the incentive levels should be market competitive in the labor markets where they compete for talent and 2) the plan should reflect the organization's unique business objectives.

Ameren's incentive plans are consistent with these objectives and principles. Ameren establishes aggressive goals for their incentive awards and holds incumbents accountable for meeting their expected level of performance. In addition, the practice of providing incentive compensation to employees at all levels of the organization is a competitive practice. My analysis of how Ameren's level of incentive compensation compares to plans across the utility industry indicates that it is at average levels of the market. The base salary plus the average incentive payout over the past three years indicates that Ameren is at 100% of the market median.

In addition, as part of my testimony, I have prepared an **Executive Summary** attached hereto as Appendix A.

Q. Please describe Mercer Human Resource Consulting's (Mercer's) expertise.

A. Mercer is a premier global human resource consulting firm with over 13,000 employees in 40 countries worldwide. Mercer's consulting services cover broad human capital strategy as well as in-depth consulting expertise through the Reward and Talent Management practice in compensation assessment, reward strategy, incentive design, and talent management. Mercer has approximately 300 consultants in the United States in the Reward and Talent Management practice. Mercer works with clients across industry ranging from Fortune 500 companies to clients with less than 100 employees.

Q. Please describe Mercer's work in compensation assessment.

A. A compensation assessment typically involves the determination of competitive market rates for all elements of direct compensation. These elements include base salary, annual bonus, and long-term / equity incentives. This is generally done by benchmarking compensation data for client positions to compensation data reported for similar positions in published or proprietary compensation surveys. Mercer has a dedicated organization with expertise in market pricing positions and is a major provider of survey data.

Q. Please describe Mercer's work in reward strategy and incentive design.

A. A design project generally begins with an assessment of the organization, its priorities, labor market issues and performance. We use this understanding as a foundation for establishing the rationale and mechanics of an incentive plan. In our consulting, Mercer has a strong emphasis on pay-for-performance and on designing plans that will reward improvements in organizational performance. Hence, our initial understanding of the organization ensures we know how pay and performance should align with each unique organization.

Q. What are the objectives of an incentive program?

A. Organizations typically design incentive plans to meet objectives of attracting, retaining, and/or motivating employees. The opportunity to receive incentives can attract potential employees that the organization is interested in hiring as well as support retention of current employees. Incentive programs can also motivate employees to focus on performance goals by linking payouts to specific measures. Incentive plans differ, depending on the character and relative importance of these performance goals.

Q. In your view, are there principles or standards of incentive design?

A. Yes. When we design an incentive plan we strive to align two factors: 1) that incentive levels provide a competitive opportunity; and 2) that the plan reflects the organization's unique business and financial objectives. Incentive design should balance appropriate incentive levels, defined by the organization's key markets for labor and the performance needs or expectations of the business. Without a clear understanding of this balance an organization could potentially pay at an appropriate competitive position in the market, but if the company does not receive the benefits of improved performance, then one could argue that the incentives were not effective.

Q. How does an organization identify the appropriate labor market?

A. Organizations compete with each other for talent in the labor market. The appropriate labor market is a segment (e.g. defined by industry or geography) in which the organization directly competes for the skills and capabilities of people needed to succeed operationally. Different employee groups exist in different labor markets. For example, the labor market for executive positions tends to be national whereas the labor market for lower-level positions tends to be regional or local. In the case of utilities, an organization would likely recruit for its line operational positions against other utilities (e.g., for Power Plant and Transmission Engineers). Talent for staff positions such as finance and human resources is likely drawn from a wider cross-section of industries (i.e., general industry).

Q. You discussed performance, how does this factor into compensation analysis?

A. Incentive design must take into account the performance expectations of investors, ratepayers and other stakeholders. Performance measures and goals should reflect the strategic and financial objectives of these interests to support the on-going success of the business. One factor in assessing whether performance goals are appropriate is whether other utilities are using similar measures. Therefore, companies should compare themselves to other companies providing similar products or services and similar levels of financial performance. A well-defined incentive plan can be a powerful tool in aligning the interests of employees (through financial incentives) and ratepayers (through better performance). Understanding performance is therefore one of the fundamental elements of incentive design.

Q. Are there any other principles of incentive design that are important in your work?

A. Yes. An effective incentive plan design creates 'line-of-sight' for the participants. This means that the participants understand how they can influence the measures in the incentive plan. A highly complex plan may best reflect organizational performance, but for the plan to be effective, participants need to understand how they can impact the measure. There is often a tradeoff between selecting measures that are highly accurate versus measures that are simple and meaningful to participants. A good plan balances these.

Q. Is Ameren's overall pay strategy reasonable?

A. Yes. Ameren defines competitiveness relative to the median or 50th percentile of the market for both base pay and incentive pay. This is a very reasonable strategy and in my consulting experience, is consistent with 90% of my clients (the other 10% are almost all above the median of the market).

Q. How do Ameren's pay levels compare to other utilities?

A. Our assessment of Ameren's compensation levels for both salary and annual incentive payouts are at a reasonable position against the median of the market. Mercer considers a range of plus or minus 10% of the market median to be within the competitive range for a group of positions. Actual compensation levels typically differ from market rates due to compensation strategy and skills and experience of the incumbent. Mercer assessed the base salary and total cash compensation (base salary plus annual incentives) for 16 Ameren benchmark positions covering 136 incumbents. The Ameren positions were matched to comparable utility positions in our own surveys plus other published and proprietary compensation survey data. While this is only a sample of all Ameren positions, in our view it represents a reasonable cross-section of functions and levels to lead to a general conclusion about the competitiveness of salary and bonus.

Based on this analysis, the Ameren benchmark positions are 106% of median market base salary. Total cash compensation using the average incentive payout over the past 3 years is 100% of market median. In addition, Mercer compared Ameren's executive compensation levels to those reported in SEC filings for a peer group of fifteen comparable utility companies with revenues ranging from approximately $2.4 to $8.5 billion. Compensation levels of Ameren's Chief Executive Officer (CEO) were compared to those of the peer group CEO's. All other Named Executive Officers were compared by rank (the second-highest paid Ameren executive in terms of total cash compensation was compared to the second-highest paid executive in the peer companies).

Ameren's executive compensation levels were <u>substantially below market</u>. For the group as a whole, base salary was 92% of the peer group median with significant variation among positions. The CEO's base salary was 101% of the peer group median with all other executives below market median. Two of the executives had base pay that was less than 85% of the peer group median for their position. Ameren's overall total cash compensation (salary plus annual incentives) was 70% of the peer group. None of the executives was above 76% of market.

These levels are substantially below market, primarily because Ameren executives received lower annual incentive payouts than their peers.

Q. In the incentive plans evaluated by the Commission and in your analysis, you reference "target" levels of incentives. Please define this term.

A. In my previous answer I discussed incentive payouts made to plan participants. The incentive "target" represents the expected level of payout assuming desired performance goals are met. This is important because it presents the market competitive level of incentive that is expected but contingent on whether performance goals are met. It is the foundation of ensuring alignment between pay and performance.

Q. What else did you observe in your examination of Ameren's incentive awards?

A. When an organization designs an incentive plan it establishes target or expected performance goals and target incentive levels that are paid if that level of performance is achieved. However, since this award is contingent on performance, it is not guaranteed. In Mercer's experience, organizations typically establish performance goals so that target awards are paid 60% of the time (or higher). This calibration ensures a reasonable opportunity to receive an incentive, but with enough risk that employees will strive to achieve the performance goals in the plan. If an incentive plan is calibrated properly, it provides employees with the opportunity to earn competitive compensation for achieving the desired level of performance for the organization and ratepayers. Properly calibrated incentive plans are key tools in developing a performance oriented culture for the organization. With respect to Ameren, we observed that actual payouts for all but one of the incumbents in the benchmark positions were below target the three years under review. For all benchmark positions, payouts averaged 54% of the target incentive level.

In effect, it tells us that Ameren established aggressive goals for their incentive awards and held incumbents accountable for meeting the expected level of performance. Furthermore, if incentives continued to be paid below target, it would suggest one of two things. First, that Ameren has a pattern of establishing higher standards in its incentive plans. Second, that since incentive awards are calibrated to the market at target, then cash compensation is actually below market – since the probability of Ameren achieving target award is less than typical practice.

Q. If Ameren did not pay incentives at all, how would its compensation compare to market?

A. It would be below market and Ameren would likely experience difficulty attracting and retaining quality employees. For the benchmark positions we examined, Ameren's compensation would still be 106% of market base salary but would fall to 93% of market total cash compensation.

Q. If the incentive bonuses were put into base salary, would that help ensure the attraction and retention of employees?

A. It might, but there is a flaw to that approach. Based on the benchmark positions we examined, by moving all incentive opportunity into base salary Ameren's overall market position would be at 115% of market base salary using average actual payouts over the past 3 years (by definition, total cash compensation would remain at 100% of median – just all delivered through base salary). However, this approach to establishing market position would in effect be a guaranteed portion of compensation and would fail to support one of the basic tenets of compensation design – aligning pay with performance. In such a context, Ameren would eliminate the leveraged portion of its pay program, which would not be in the interests of either Ameren's ratepayers or its shareholders.

Q. How prevalent are incentive plans throughout the utility industry?

A. According to Mercer and other survey sources, the majority of utilities provide some type of variable pay program. Our surveys indicate that over 80% of utilities provide incentive plans for executives and approximately 2/3 have incentive programs covering a broader employee population. Even public power organizations often provide incentives, which suggests that incentive plans are considered to be in the public interest. A custom survey conducted by Mercer of selected members of the Large Public Power Council found that over 50% of public power organizations have a bonus program.

Q. How does Ameren's incentive opportunity or target compare with those seen in other utility companies?

A. Ameren's incentive levels are comparable to those seen in the utility industry. **Under the Executive Incentive Plan, incentive opportunity ranges from 20% of salary for the manager level to 60% for the CEO of Ameren. Mercer surveys indicate the median target for utility executives is 25% of base salary to 50%. Ameren's Management Incentive Plan, which covers management and salaried employees, provides targeted award opportunities of 6 to 10% of base salary. According to Mercer surveys, median targets for the utility industry range from 8% of salary for clerical and technical employees to 13% for management employees. The Ameren Incentive Plan, which covers bargaining unit employees, provides a target of 3% of salary and a maximum of

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4.5%. For hourly employees in the utility industry, the median target incentive is 5% of base salary.**

Q. How do performance measures used in Ameren's plans compare with those seen in the utility industry?

A. Overall, the measures used by Ameren in all three plans included in this review are reasonable and appropriate. For the executives, Ameren uses Earnings Per Share (EPS) to fund its Executive Incentive Plan. Actual awards, however, are based on company performance against this measure and individual performance. According to our surveys, earnings based incentive measures are among the most common across the industry. The Management Incentive Plan uses EPS to fund the pool, so again, there is strong linkage with a common measure of performance. Where the Management Incentive Plan differs slightly, however, is that actual award payouts are determined by the business line performance and individual performance. This type of plan design is observable as a "best practice" across the industry but not as common because many utilities are not yet organized into business lines. Hence, few companies distribute awards similarly to Ameren. In a similar vein, the Ameren Incentive Plan pays out based on business line and EPS results which, as with the Management Incentive Plan is not as common due to the absence of business unit measures across the industry. However, because of the prevalence of earnings based measures used across the industry, we conclude that the primary measures used by Ameren, are reasonable. Specifically, they appear to have been designed to reflect the impact of line-of-sight at lower levels of the organization (i.e., business unit and individual performance), which in our view reflects sound design principles.

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Q. What is your view of the plans' provisions for excluding non-recurring or extraordinary items?

A. This too is common practice. I mentioned that a key principle in incentive design is the need to balance line-of-sight with financial accuracy. For an incentive plan to be an effective motivational tool, participants must understand how they can impact performance. Extraordinary items are by nature difficult for most AmerenUE employees to influence. Management needs flexibility to ensure that participants are not penalized for making a decision that prevents meeting the short-term earnings goal but is appropriate for the long-term viability of the business. A plan that allows some flexibility for non-recurring events and items such as large capital investments ultimately benefits ratepayers because it promotes making the correct business decision without concern about the impact on award payouts.

Q. How do performance measures used in Ameren's plans benefit Missouri ratepayers?

A. Ameren's corporate EPS is closely tied to performance of AmerenUE. Actual payouts depend on business line or individual performance. Business line performance is measured against pre-defined Key Performance Indicators. Key Performance Indicators include goals such as improving system reliability, reducing delivery service cost per customer, and increasing customer satisfaction. Providing incentives that support reducing costs and maintaining or improving customer service are ultimately in the interests of the ratepayer. According to a recent article in *Public Utilities Fortnightly*, customer satisfaction is critical for utility companies and it tends to be a leading indicator of financial performance. The article further notes that a study of best practices concerning customer satisfaction concluded that firms with progressive programs tie customer satisfaction measure to compensation at all levels of the organization. In addition, if Ameren is able to attract and retain a high quality workforce that continues to improve upon these measures, then this also benefits customers and ratepayers. Incentive plans benefit ratepayers by motivating employees to focus on key measures of interest to ratepayers and by promoting a stable workforce.

Q. In summary then, in light of your industry knowledge, what is your view of Ameren's incentive plans in serving the interests of the customer and the organization?

A. In my view, Ameren's incentive programs benefit ratepayers as well as shareholders and employees. The level and structure of Ameren's incentives are reflective of market practice. Moreover, incentive compensation sends an important and necessary message to Ameren employees. The utility industry is experiencing a time of unprecedented change and companies face new pressures on multiple fronts. Utilities are striving to find ways to provide superior service to customers while reducing cost. The industry is consolidating, and a number of utilities are undergoing mergers or acquisitions. Volatility in energy supply and demand has created price swings that require utilities to become savvy in finding the most effective way to deliver power to customers. These changes make it more important for utilities to attract and retain quality talent at a time when non-regulated energy organizations are often providing premium compensation levels for key talent. To survive in this changing environment, utilities are working to foster an even stronger performance orientation. Incentives that promote sound fiscal management and customer satisfaction can help create a stronger Ameren, which ultimately benefits customers.

Q. Does this complete your testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission, Complainant,	)	
vs.	)	Case No. EC-2002-1
Union Electric Company, d/b/a AmerenUE, Respondent.	)	

AFFIDAVIT OF DAVID CROSS

STATE OF MISSOURI)
) ss
CITY OF ST. LOUIS)

David Cross, being first duly sworn on his oath, states:

1. My name is David Cross. I work in Philadelphia, Pennsylvania, and I am employed at Mercer Human Resource Consulting.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 14 pages and Appendix A, which has been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

David Cross

Subscribed and sworn to before me this 7th day of May, 2002.

Notary Public

My commission expires:

NOTARIAL SEAL
ROSE MARIE M. O'KEEFE, Notary Public
East Whiteland Twp., Chester County
My Commission Expires September 19, 2005

EXECUTIVE SUMMARY

David Cross

Principal and Senior Consultant, Mercer Human Resource Consulting, specializing in "Reward and Talent Management" practice for utilities and energy service organizations

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Ameren's Incentive Compensation Program is an integral part of the company's overall compensation package, which ties a portion of all employees' pay to performance. In Ameren's plans, the performance that is used to measure whether an employee receives any incentive pay includes individual performance, the performance of the business line or function the employee works in, and the performance of the company as a whole. The goals that are established in Ameren's plans appear aggressive, which means that the probability of employees achieving those goals is actually less than is typically found in similar plans.

If no incentives were available, Ameren compensation levels would not be competitive and Ameren would likely experience difficulty attracting and retaining qualified employees. To keep compensation levels competitive and have no incentive compensation would eliminate the worthy goal of aligning pay with performance, which would not be in the best interest of ratepayers or shareholders.

Approximately 80% of utilities have incentive compensation programs. Although Ameren's plans appear to set more aggressive goals than most, their design is comparable to those typically found in the utility industry. Moreover, the use of Earnings per Share (EPS) to fund the plans and as a performance measure, is very common and appropriate. It is also appropriate and typical to adjust the EPS – up or down – to take into account extraordinary items. This is a typical way to ensure that participants are not penalized – nor rewarded – inappropriately.

Contrary to the Staff's recommendation, Ameren's plans are particularly keyed to encouraging performance that will benefit Missouri ratepayers. Actual payouts depend on business line and individual performance. Business line performance is measured against pre-defined Key Performance Indicators, such as improving system reliability, reducing delivery cost per customer, and increasing customer satisfaction. These, as well as others, directly benefit customers.

Ameren's Incentive Compensation Plans should be encouraged by the Commission. The costs associated with those plans should be allowed. They send an important and necessary message to Ameren employees. Incentives that promote sound fiscal management and customer satisfaction can help create a strong, customer oriented company, which will be able to provide good customer service, benefiting Missouri customers.