

Exhibit No.:
Issues: Incentive Compensation
Witness: David Cross
Sponsoring Party: Mercer Human Resource Consulting
Type of Exhibit: Rebuttal Testimony
Case No.: EC-2002-1
Date Testimony Prepared: May 10, 2002

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
Date 7/11/02 Case No. EC-2002-1
Reporter RL

**** DENOTES PROPRIETARY INFORMATION ****

St. Louis, Missouri
May, 2002

NP

1 for six years. As the Manager of Human Resource Information for EEI, I managed
2 and/or developed annual industry-wide compensation surveys including Executive
3 Compensation, the Management Administrative & Professional (MAP) Survey, the
4 Non-Exempt Wage Survey, and the Collective Bargaining Survey. Some of the utility
5 clients for whom I have conducted compensation projects include Potomac Electric
6 Power Company, Arizona Public Service, Cinergy, Knoxville Utilities Board, Kansas
7 City Power & Light and Omaha Public Power District.

8 **Q. Please provide a summary of your testimony.**

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

17 Ameren's incentive plans are consistent with these objectives and
18 principles. Ameren establishes aggressive goals for their incentive awards and holds
19 incumbents accountable for meeting their expected level of performance. In addition, the
20 practice of providing incentive compensation to employees at all levels of the
21 organization is a competitive practice. My analysis of how Ameren's level of incentive
22 compensation compares to plans across the utility industry indicates that it is at average

1 levels of the market. The base salary plus the average incentive payout over the past
2 three years indicates that Ameren is at 100% of the market median.

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

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

7 A. Mercer is a premier global human resource consulting firm with over
8 13,000 employees in 40 countries worldwide. Mercer's consulting services cover broad
9 human capital strategy as well as in-depth consulting expertise through the Reward and
10 Talent Management practice in compensation assessment, reward strategy, incentive
11 design, and talent management. Mercer has approximately 300 consultants in the United
12 States in the Reward and Talent Management practice. Mercer works with clients across
13 industry ranging from Fortune 500 companies to clients with less than 100 employees.

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

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

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

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

8 **Q. What are the objectives of an incentive program?**

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

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

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

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

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

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

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

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

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

10 **Q. Is Ameren's overall pay strategy reasonable?**

11 A. Yes. Ameren defines competitiveness relative to the median or 50th
12 percentile of the market for both base pay and incentive pay. This is a very reasonable
13 strategy and in my consulting experience, is consistent with 90% of my clients (the other
14 10% are almost all above the median of the market).

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

16 A. Our assessment of Ameren's compensation levels for both salary and
17 annual incentive payouts are at a reasonable position against the median of the market.
18 Mercer considers a range of plus or minus 10% of the market median to be within the
19 competitive range for a group of positions. Actual compensation levels typically differ
20 from market rates due to compensation strategy and skills and experience of the
21 incumbent. Mercer assessed the base salary and total cash compensation (base salary
22 plus annual incentives) for 16 Ameren benchmark positions covering 136 incumbents.
23 The Ameren positions were matched to comparable utility positions in our own surveys

1 plus other published and proprietary compensation survey data. While this is only a
2 sample of all Ameren positions, in our view it represents a reasonable cross-section of
3 functions and levels to lead to a general conclusion about the competitiveness of salary
4 and bonus.

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

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

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

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

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

8 **Q. What else did you observe in your examination of Ameren’s incentive**
9 **awards?**

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

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

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

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

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

16 A. It might, but there is a flaw to that approach. Based on the benchmark
17 positions we examined, by moving all incentive opportunity into base salary Ameren's
18 overall market position would be at 115% of market base salary using average actual
19 payouts over the past 3 years (by definition, total cash compensation would remain at
20 100% of median – just all delivered through base salary). However, this approach to
21 establishing market position would in effect be a guaranteed portion of compensation and
22 would fail to support one of the basic tenets of compensation design – aligning pay with
23 performance. In such a context, Ameren would eliminate the leveraged portion of its pay

1 program, which would not be in the interests of either Ameren's ratepayers or its
2 shareholders.

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

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

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

14 A. Ameren's incentive levels are comparable to those seen in the utility
15 industry. ** _____

16 _____
17 _____
18 _____
19 _____
20 _____
21 _____
22 _____
23 _____

NP

1

2

..**

3

4

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

5

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.

23

NP

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

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

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

15 A. Ameren's corporate EPS is closely tied to performance of AmerenUE.
16 Actual payouts depend on business line or individual performance. Business line
17 performance is measured against pre-defined Key Performance Indicators. Key
18 Performance Indicators include goals such as improving system reliability, reducing
19 delivery service cost per customer, and increasing customer satisfaction. Providing
20 incentives that support reducing costs and maintaining or improving customer service are
21 ultimately in the interests of the ratepayer. According to a recent article in *Public*
22 *Utilities Fortnightly*, customer satisfaction is critical for utility companies and it tends to
23 be a leading indicator of financial performance. The article further notes that a study of

1 best practices concerning customer satisfaction concluded that firms with progressive
2 programs tie customer satisfaction measure to compensation at all levels of the
3 organization. In addition, if Ameren is able to attract and retain a high quality workforce
4 that continues to improve upon these measures, then this also benefits customers and
5 ratepayers. Incentive plans benefit ratepayers by motivating employees to focus on key
6 measures of interest to ratepayers and by promoting a stable workforce.

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

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

Rebuttal Testimony of
David Cross

- 1 promote sound fiscal management and customer satisfaction can help create a stronger
- 2 Ameren, which ultimately benefits customers.

3 **Q. Does this complete your testimony?**

4 **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 ____ 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 ____ day of May, 2002.

Notary Public

My commission expires:

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*

* * * * *

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.