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Issues:	*Incentive Compensation*
	Rate Case Expense
Witness:	*Casey Westhues*
Sponsoring Party:	*MoPSC Staff*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

CASEY WESTHUES

THE EMPIRE DISTRICT ELECTRIC COMPANY

FILE NO. ER-2011-0004

Jefferson City, Missouri
April 2011

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Q. Please state your name and business address.

A. Casey Westhues, 200 Madison Street, Suite 440, Jefferson City, MO 65101.

Q. Are you the same Casey Westhues who participated in the preparation of the Staff's Cost of Service Report, filed February 23, 2011, for this case?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony addresses the rebuttal testimonies of The Empire District Electric Company ("Empire" or "Company") witness Dale W. Harrington, regarding the Company's incentive compensation expense, and The Office of the Public Counsel (OPC) witness Shawn Lafferty regarding rate case expense.

EXECUTIVE SUMMARY

Q. Please provide a brief summary of your testimony.

A. This testimony addresses Staff's position regarding incentive compensation expense at Empire. The incentive compensation adjustments proposed by Staff apply to three different forms of compensation offered by Empire: (1) the Management Incentive Compensation Plan (MIP) for short-term executive incentive compensation; (2) "Lightning Bolts" for short-term discretionary incentive compensation to non-management employees;

and (3) long-term equity incentive compensation to executives. Staff does not object to Empire's practice of offering its employees variable compensation based on attainment of certain goals. However, Staff recommends incentive compensation for all employees should be based on goals that provide a direct benefit to ratepayers, not goals that primarily or entirely benefit shareholders.

This testimony also addresses the inclusion of rate case expenses in the cost of service. Staff believes that rate case expense is properly included as a cost to be recovered in rates, as it is a cost associated with the present utility regulatory system that directly benefits the ratepayers. The regulatory system is set up to protect customers by requiring a company to apply to the Missouri Public Service Commission ("Commission") for a rate increase. In this way, it allows the Commission the opportunity to examine all costs incurred by a company for prudence and reasonableness before changing a utility's rates. Staff's current position is that a normal level of prudent and reasonable costs incurred in applying for a rate increase are necessary as part of the current regulatory system and should be allowed rate recovery.

INCENTIVE COMPENSATION

Management Incentive Plan

Q. Please explain the executive compensation program at Empire.

A. The executive compensation program at Empire, known as the Management Incentive Compensation Plan (MIP), is comprised of three basic elements: (1) base salary; (2) annual (short-term) cash incentives based on threshold (minimum expected), target, and maximum performance measures; and (3) long-term incentive plans (LTIP)

Q. Out of the three elements mentioned above, what are the areas of disagreement between Staff and the Company?

A. The disagreements concern the annual (short-term) cash incentives and the long-term incentives. Staff is not proposing to adjust Empire executive's base salaries.

Q. What is Empire's position in regards to its overall compensation methodology?

A. On page 3, lines 16 to 23, and page 4, lines 1-3 of Mr. Harrington's rebuttal testimony, he states:

> Companies similar to Empire typically utilize the same approach as Empire by incorporating a mix of base salary, short-term, and long-term incentives into a total executive compensation package. This reflects a 'best practices' approach used by companies both inside and outside the utility industry. Rather than relying solely on fixed compensation in the form of base salary, this best practices approach also includes a considerable measure of variable (at risk) compensation in the total compensation package. This approach is a key factor in ensuring the alignment of an executive's performance with the interests of customers and shareholders. The approach is utilized by each of the peer-group companies as well as all investor owned electric utilities operating in Missouri (inclusively, the "comparator companies").

Q. How does Staff respond to the above mentioned portion of Mr. Harrington's rebuttal testimony?

A. Staff agrees with Mr. Harrington's statement that all investor-owned electric utility companies in Missouri include a mix of base salary, short-term, and long-term incentives built into their total executive compensation package. Staff would also note many large gas and water utilities in Missouri include similar mixes in their total executive compensation packages. However, at many Missouri regulated utilities, Staff has recommended the disallowance of incentive compensation components that are primarily intended to maximize shareholder wealth or do not provide a direct benefit to ratepayers. The position Staff is taking in this matter is no different than what it has recommended in past rate cases for Empire and other Missouri utilities.

Q. Is Staff opposed to the recovery of "at risk" executive incentive compensation?

A. No. Staff is not opposed to a portion of executive compensation being placed "at risk." If Empire shows that this approach is based upon goals and objectives that result in a ratepayer benefit, Staff would not oppose recovery of these costs in the cost of service.

Q. In his rebuttal testimony on page 5, Mr. Harrington attempts to justify rate recovery for its executive incentive compensation expenses on the grounds that Empire's total compensation package for its executives is lower than that of other "comparator utilities." Please comment.

A. Mr. Harrington appears to be arguing that the Commission should place a different and more lenient ratemaking standard for incentive compensation on utilities that are perceived to pay less in compensation expenses than the industry or area norm. However, Staff believes this argument misses the real point of this issue. Staff is not proposing its adjustments to Empire's incentive compensation expense on the grounds that Empire's incentive compensation is "excessive" or that it would cause Empire's total compensation package for executives to be "excessive;" rather, Staff's adjustments are based upon the belief that it is inappropriate to charge customers for costs primarily associated with shareholder benefit or that do not result in real improvement in utility performance. Whether a utility pays high or low total compensation levels should not affect this fundamental fairness concern.

Q. Mr. Harrington seems to imply that a company's compensation package should be judged in total, based upon the amount of total compensation, with no separate or distinctive criteria applied to variable incentive-type compensation. Do you agree?

A. No. Base salaries and incentive compensation are distinct types of employee compensation, and the Commission has historically applied specific criteria before allowing incentive compensation expense to be included in rates. The Commission's criteria has been based upon whether attainment of a Company's goals/targets would provide a benefit to its customers, and whether the goals/targets are designed to actually improve employee and company performance. Staff recommends that the Commission continue this assessment before including incentive compensation costs in customer rates.

Q. Please explain Empire's long term incentive plan (LTIP).

A. Empire's LTIP consists of stock options, dividend equivalent rights awarded in conjunction with each stock option grant, and performance-based restricted stock awards.

Q. Why does Staff propose to disallow the LTIP awards?

A. Staff proposes to disallow LTIP awards for the following reasons: (1) the awards are based on measures that primarily benefit shareholders, such as shareholder return (maximizing the dividends paid to shareholders) and stock price goals (the value of the stock increasing over time); (2) the granting of these stock options is not associated with any increase in duties or achievement of goals and are not tied to any specific level of employee performance; and (3) the stock options and performance-based restricted stock are equity-based compensation that do not result in cash outlays from the company and should not be recovered in cash through rates.

Q. Please explain your last point further.

A. When a stock option or performance-based restricted stock is granted to a management employee, no cash is exchanged. The stock-related grant gives the receiver of the grant an option (right) to purchase stock at a discount from its market value at a future date. No cash is paid out by Empire at the time of the grant/option or when the employee exercises the grant/option to acquire Company stock. When the grant/option is exercised, the grant/option-holder pays cash to the Company and the Company issues stock. Empire does not pay out cash to the grant/option holder at either point.

Q. On page 6 of his testimony, Mr. Harrington references specific adjustments that Staff made to disallow a portion of the executive incentive compensation and makes the statement that these adjustments are unreasonable. Please comment.

A. Mr. Harrington makes the statement that Staff's adjustments are unreasonable because no awards are payable to an executive officer unless they perform above the minimum or threshold level of performance. What Mr. Harrington doesn't take into account is what each specific goal pertains to. He seems to be saying that Staff should not be looking at each individual goal for reasonableness because they are all a part of the total compensation package and it should not matter what each specific goal is. Staff disagrees with this line of reasoning and believes that each individual goal should be scrutinized to see if it has a direct benefit to ratepayers or is a part of the normal job duties of an executive and does not go above and beyond their normal daily work. Staff disallowed only those awards given to executives that did not have a direct benefit to ratepayers or that appeared to be part of normal job duties such as goals related to meeting attendance, record management, and financing of capital expenditures.

As had been customary in past rate cases, Staff allowed incentives related to customer service, reliability and safety, and environmental compliance, because these goals are associated with the provision of safe, adequate and reliable service to the ratepayers.

Q. Has the Commission previously expressed its view on the appropriate rate treatment of incentive plans?

A. Yes. In the Commission's Report and Order issued in Case No. GR-96-285, Missouri Gas Energy (MGE), the Commission stated in its opinion relating to incentive plans developed using shareholder-oriented financial measures:

> The Commission finds that the costs of MGE's incentive compensation program should not be included in MGE's revenue requirement because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers. 5 Mo.P.S.C.3d 437,458 (January 22, 1997).

The Commission reiterated its position in its Report and Order in Case No. GR-2004-0209, MGE:

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

The Commission further reiterated its position in its Report and Order in Case No. ER-2006-0315, Empire:

> The Commission finds that the Staff reasonably applied objective criteria for exclusion of certain incentive compensation. The Staff disallowed compensation related to charitable activities and activities related to the provision of services other than retail electric service…. We conclude that incentive compensation for meeting earnings goals, charitable activities, activities unrelated to

> the provision of retail electric service, discretionary awards, and stock options should not be recoverable in rates.

The Commission also reiterated its position on incentive compensation matters in its Report and Orders in Case Nos. ER-2006-0314 and ER-2007-0291, both Kansas City Power and Light Company (KCPL) rate cases.

Non-Executive Salaried Compensation

Q. In regards to the non-executive salaried employee incentive compensation issue, is it true as referenced in Mr. Harrington's rebuttal testimony at page 11, lines 9 to 10, Staff disallowed $110,243 in expense related to this item that was paid in common stock rather than cash?

A. Yes, this is correct. Again, it is Staff's position not to allow non-cash incentive compensation expenditures in the cost of service. Since the Company paid these employees in stock rather than cash, there was no cash expense.

Lightning Bolts

Q. Did Staff disallow Empire's "Lightning Bolt" awards in the amount of $47,500?

A. Yes. Staff disallowed the entire test year amount of Lightning Bolt expense.

Q. Mr. Harrington states the Lightning Bolt Program provides cash awards to non-executive salaried individuals who deliver results beyond those normally associated with their position. What is the main reason for Staff's disallowance of Lightning Bolts?

A. Lightning Bolts do not have any pre-set goals or objectives attached to them that employees can "work toward," and they are paid out at the senior management's discretion.

Q. What has been the Commission's policy regarding incentives that do not have any goals attached to them?

A. The Commission stated its position in its Report and Order in Case No. ER-2006-0315 Empire's 2006 rate case:

> The Staff disallowed the Lightning Bolts incentive compensation, as they did not relate to the provision of electric service and there were no performance criteria for receipt of the awards; they were given solely at the Company management's discretion.

Q. What does the Commission need to include in its Report and Order to effectuate Staff's recommendation on incentive compensation?

A. The Commission should not include incentive compensation for management compensation, non-salaried incentive compensation and lightning bolts programs as discussed above.

<u>RATE CASE EXPENSE</u>

Q. What is OPC witness Lafferty's position in this case regarding rate case expense?

A. Mr. Lafferty advocates that all costs incurred by Empire in this proceeding for outside consultants retained in performing the rate of return study and the depreciation study be disallowed. He contends that the remaining reasonable and prudent rate case expenses should then be split 50/50 between the ratepayers and the shareholders.

Q. What is Staff's current position on rate case expense?

A. Staff understands that a regulated utility is entitled, under traditional ratemaking concepts, to rates that allow a reasonable opportunity for recovery of all reasonable and prudent amounts expended in rending utility service to customers. This opportunity extends to costs incurred by the utility to set new rates within the established regulatory process in Missouri. The general rules governing rate case expense provide that those expenses that are known and measurable, reasonable, necessary, and prudently incurred in the preparation and presentation of a company's case may be included in the allowable expenses of the company. Some examples of rate case expense are: legal fees from outside counsel, consulting fees, expert witness fees, shipping expense and costs incurred by company employees to attend case-related activities in Jefferson City. Staff typically normalizes rate case expenses for a rate case over a specified period of time based on the average time between a company's prior and future rate case filings. Staff, however, believes it is inappropriate in most circumstances to allow specific recovery in rates of amounts related to prior case proceedings. Staff's policy is to recommend recovery in rates of normalized rate case expenses only on a prospective basis.

Q. Does Staff believe that Empire should be allowed the opportunity to recover costs associated with the use of outside consultants in support of a rate case?

A. Yes, as long as the expenses incurred are known and measurable, reasonable, necessary and prudently incurred. Utilities should have reasonable discretion to hire outside consultants in rate proceedings.

Q. Is it a normal practice for utilities to hire outside consultants in the areas of rate of return analysis and production of depreciation studies, as Empire has in this rate proceeding?

A. Yes. In recent years, all or almost all major utilities in this state have hired outside consultants to sponsor or assist in rate of return analyses. Also, in recent years all or almost all major utilities in this state have hired outside consultants to sponsor or assist in the preparation of depreciation studies, when such studies have been offered in rate cases by utilities.

Q. Has it been Staff's position that rate case expenses be shared by the Company's shareholders?

A. No. Staff's position has been that, under the existing regulatory system in this jurisdiction, a utility is required to incur certain costs in attempting to establish new rate levels. Given the fact, rate case expenses are a necessary cost for utilities to incur. As with all necessary costs incurred in providing utility service, reasonable and prudent rate case expenses should be included in a utility's cost of service for purposes of setting rates.

The Commission currently has opened a docket, Case No. AW-2011-0330, to review issues concerning rate case expense. It is Staff's understanding that these issues may include consideration of potential "sharing" of rate case expense between ratepayers and shareholders in the future. Pending any actions taken in that docket, Staff recommends that the Commission maintain its past position on recovery of rate case expense in this proceeding.

Q. Does Staff believe that any costs incurred by Empire in the current case are imprudent or unreasonably incurred?

A. No, not at this time. Furthermore, all costs incurred to date for this proceeding are in line with costs that have been incurred in prior cases. However, rate case expense is an ongoing expense that is incurred up to the closing of the case. Any rate case expenses for this case incurred in the future by Empire will continue to be reviewed by Staff to ensure they are reasonable and prudently incurred.

Q. What is Staff's proposed action when it comes to Rate Case Expense?

A. Staff proposes that Empire's rate case expenses in this proceeding be treated in the normal fashion and be considered for inclusion in the cost of service in this rate proceeding.

Q. What does the Commission need to include in its Report and Order to effectuate Staff's recommendation on rate case expense?

A. The Commission should include all prudently incurred rate case expenses throughout the case, and normalize that cost over a four-year period.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company of Joplin, Missouri for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	))))	File No. ER-2011-0004

AFFIDAVIT OF CASEY WESTHUES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Casey Westhues, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 12 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Casey Westhues
Casey Westhues

Subscribed and sworn to before me this 28th day of April, 2011.

Nikki Senn
Notary Public

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016