Exhibit No.:	
Issues:	*Incentive Compensation, Coal Inventory Base Mat, Fuel and Purchased Power*
Witness:	*Keith D. Foster*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No:	*ER-2010-0130*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

KEITH D. FOSTER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2010-0130

Jefferson City, Missouri
April 2010

** Denotes Highly Confidential Information **

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SURREBUTTAL TESTIMONY OF

KEITH D. FOSTER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2010-0130

Q. Please state your name and business address.

A. Keith D. Foster, 200 Madison Street, Suite 440, Jefferson City, MO 65101.

Q. Are you the same Keith D. Foster who participated in the preparation of the Staff's Cost of Service Report, filed February 26, 2010, 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) witnesses Dale W. Harrington, regarding the Company's incentive compensation expense; Brian J. Berkstresser, regarding the inclusion of base mat in the coal inventory; and Todd W. Tarter, regarding on-system fuel and purchased power.

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 the Staff apply to three different forms of compensation offered by Empire, discussed on pages 74 to 75 of Staff's Cost of Service Report: (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 benefit ratepayers, not goals that benefit shareholders.

This testimony also addresses the inclusion of "base mat" in the coal inventory for Empire's Asbury and Riverton coal-fired power plants, as well as issues raised on fuel price model input variables used in the calculation of Staff's Fuel and Purchased Power adjustments.

INCENTIVE COMPENSATION

Staff Changes – Incentive Compensation

Q. What changes to its proposed adjustments has Staff made regarding test year incentive compensation expense?

A. Company Witness Dale W. Harrington discusses in his rebuttal testimony that Staff had excluded, from the cost of service, compensation associated with certain performance measures from the annual cash incentive plan of Empire's executive compensation program, including the cash incentive goals related to meetings with institutional investors, issuances of debt, and participation in the Southwest Power Pool board and committee activities. After further review by Staff, we now agree with the Company in regards to these specific criteria and have included the amounts associated with these items in the cost of service in this case. These changes reduce the Staff's disallowance related to the MIP by a total of ** _______ **.

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 to 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. This 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 is in agreement with Mr. Harrington in understanding 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. At many utilities, Staff has recommended the disallowance of incentive compensation components that are intended to maximize shareholder wealth or do not provide a direct benefit to ratepayers. The positions the Staff is taking in this proceeding are no different than what it has recommended in past rate cases for Empire and other Missouri utilities.

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

A. No. The 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 ratepayer benefits, the Staff would not oppose recovery of these costs in the cost of service.

Q. In his rebuttal testimony, 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 Missouri Public Service Commission (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, the Staff believes this argument misses the real point of this issue. The 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 premised upon the belief that it is simply inappropriate to charge customers "in rates" 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. Please explain Empire's 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 these awards for the following reasons: (1) the awards are based on 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. In Mr. Harrington's rebuttal testimony, he specifically mentions Staff allowed in test year expense cash incentive compensation awards for specific executives while disallowing the same types of awards for other executives and that such action was "inappropriate, arbitrary, and capricious." Would you care to comment?

A. Yes I would. First, let me refer to page 75, lines 1 to 7, of Staff's Cost of Service Report, where I stated:

> Related to the MIP, the Staff eliminated the recovery of awards associated with meeting (but not exceeding) budgetary goals and any awards related to attainment of earnings goals. In the Staff's view, since financial goals directly benefit shareholders, shareholders should bear the cost of these incentives.
>
> The Staff's position on this matter in this case is consistent with the Commission's disallowance of certain MIP expenses in the Commission's Report and Order in a prior Empire rate case, ER-2006-0315.

In the case of the cash incentives related to the operating and maintenance expense controls performance measure, Mr. William Gipson and Mr. Greg Knapp were, respectively, ** ________________________ ** while Mr. Brad Beecher, Mr. Harold Colgin, Mr. Michael Palmer, and Ms. Kelly Walters were, respectively, ** ________________________________ _____ ** As noted above, since Staff does not allow awards for exceeding budgetary goals, the amount of incentives awarded to those executives who went over budget was eliminated. As Mr. Harrington correctly noted in his rebuttal testimony, the total amount disallowed in this area was $15,650. The total amount allowed for the two executives who came in under budget was ** ________ **

Likewise, in the case of the cash incentives related to the control of capital expenditures performance measures, Mr. Beecher, Mr. Colgin, and Mr. Palmer were, respectively, ** ________________________________ ** while Mr. Gipson and Ms. Walters were, respectively, ** ________________________ ** Again, since Staff does not allow awards for exceeding budgetary goals, the amount of incentives awarded for this performance measure to those executives who went over budget was eliminated. As Mr. Harrington correctly noted in his rebuttal testimony, the total amount disallowed in this area was $9,741. The total amount allowed for the three executives who came in under budget was ** ________ **

Similarly, in the case of the cash incentives related to the control of capital expenditures for construction of the Iatan 2 and Plum Point plants performance measures, Mr.Gipson, Mr. Beecher, and Mr. Colgin were each ** _______________ ** And, for control of fuel and purchased power expenses, Mr. Gipson, Mr. Beecher, and Mr. Colgin were each ** _______________ ** Again, since Staff does not allow awards for exceeding budgetary goals, the amount of incentives awarded for this performance measure to those executives who went over budget was eliminated. As Mr. Harrington correctly noted in his rebuttal testimony, the total amounts disallowed in these areas were $10,387 and $32,298, respectively.

Staff's treatment of these cash incentives is not inappropriate, nor arbitrary, nor capricious, as Mr. Harrington states. Staff's long-standing position has been to not allow awards for exceeding budgetary goals and Staff has consistently disallowed Empire's cash incentives to those executives who did exceed budgets, as is appropriate under Staff's position. Staff did not arbitrarily allow some cash incentives for these performance measures and not others as Staff consistently disallowed cash incentives for those executives who exceeded the budget and consistently allowed cash incentives for those executives who were under budget. And by following a consistent documented methodology, and not by some whim or fancy, Staff's treatment of these incentives cannot reasonably be characterized as capricious.

It is important to note for all the aforementioned performance measures, Empire's threshold, or minimum, target is ** ______________ **. This means an executive will always get a cash incentive as long as he or she does not exceed this threshold. Although this may be considered in the realm of "best practices," the fact that an executive should receive a cash incentive at ratepayer expense for exceeding the budget is absurd and defies any logical reasoning. If the Company wants to award its executives for exceeding the budget, then it should do so only at shareholder expense, not as an expense borne by the ratepayers.

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

Q. What other amounts did Staff disallow from the test year short-term cash incentive expense?

A. One type of objective disallowed by Staff were any related to working on Missouri rate case filings to achieve higher rates for Empire. Another example was a specific incentive for a 100-year anniversary plan was disallowed for Ms. Walters because it did not appear to provide a benefit to the ratepayers. The Staff believes these objectives do not provide a direct benefit to electric 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. 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.
>
> 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 No. ER-2006-0314, and Case No. ER-2007-0291, both Kansas City Power and Light Company (KCPL).

<u>Non-Executive Salaried Compensation</u>

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 13, lines 5 to 6, Staff disallowed $380,557 in expense related to this item that was paid in common stock rather than cash?

A. Yes, this is correct. 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. As Mr. Harrington states on page 13, lines 13 to 14, "…there was an immediate need to conserve cash." So, no cash expense occurred in the test year.

Q. Is payment of stock in lieu of a cash salary a normal occurrence for Empire?

A. According to Mr. Harrington's response to Staff Data Request Number 0349, question 1): "the option to elect stock rather than cash had not been extended to non-executive salaried employees at any time in the past." However, in the next two paragraphs, Mr. Harrington states:

> Since the conditions that necessitated cash conservation as described in my testimony continued to exist in early 2010, the same offer was extended to qualifying non-executive salaried employees during the compensation evaluation and award time again this year. The election period was from January 6 to January 29, 2010.
>
> No decision has been made to continue this exception to normal practice in the future.

Therefore, it is possible the practice of extending payment in stock versus cash has continued at least one year past the test year.

<u>Lighting Bolts</u>

Q. Did Staff disallow Empire's Lightning Bolt awards in the amount of $69,972?

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 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.

> We conclude that the 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.

COAL INVENTORY BASE MAT

Q. What is the issue in this proceeding related to the inclusion of "base mat" in the coal inventory for Asbury and Riverton power plants?

A. The issue is whether or not a valuation of "base mat" should be included in the coal inventory for rate base.

Q. What is the Company's position on this issue?

A. As addressed on page 3, lines 15 to 18 of Mr. Berkstresser's rebuttal testimony, the Company believes Staff's coal inventory calculation should be adjusted to include base mat in the rate base. Specifically, he is proposing the Asbury coal inventory be increased by $897,443 and the Riverton coal inventory by $307,164, for a total increase of $1,204,607.

Q. Had Staff been provided information for Empire's base mat prior to submission of the Staff's Cost of Service Report?

A. Not that I am aware of. The first time the issue was raised was in Mr. Berkstresser's rebuttal testimony.

Q. Briefly describe "base mat."

A. "Base mat" is the term applied to coal that forms the base of a coal pile which protects the coal in the pile from the ground. This is coal that, over the years, has been compacted into the soil and has become unburnable.

Q. Is Staff opposed to including an amount for base mat in the rate base coal inventory for the Asbury and Riverton power plants?

A. No, not in concept. However, Empire's quantification of the base mat amount of coal inventory referenced in Mr. Berkstresser's surrebuttal testimony appears to be based upon a current market valuation of coal inventory. Staff's understanding is that the actual base mat at Empire's Asbury and Riverton generating stations relates to coal delivered to these sites decades before. Valuation of this inventory at current market prices would result in an overstatement of the cost of this asset for ratemaking purposes.

The Staff has submitted a data request to Empire seeking more accurate information regarding the original cost of base mat coal. Once that information is received, the Staff will evaluate its position on an appropriate valuation of Empire's base mat coal.

FUEL AND PURCHASED POWER

Q. Mr. Tarter brings up concerns regarding the natural gas price assumed in Staff's Fuel and Purchased Power model. Would you care to comment?

A. Yes, I would. Mr. Tarter notes Staff used a weighting of 81% hedged natural gas price and 19% spot price to derive its overall recommended natural gas price, and these percentages of hedged and spot gas usage were based upon the Company's projections of natural gas usage for 2010. Mr. Tarter goes on to state the actual gas usage assumed in the Staff's fuel model is significantly less than what the Company has budgeted for in 2010, and to be consistent with this lower usage the Staff should have assumed 89% of its gas costs were hedged and only 11% related to spot purchases. The higher percentage of assumed hedged gas costs, in turn, would result in a higher assumed gas price for purposes of estimating Empire's power production costs.

Q. Does Staff find Mr. Tarter's argument to be persuasive?

A. Not at all. Staff's weighting of hedged and spot gas usage is in line with the Company's own hedging policy, irrespective of the volume of gas assumed. Empire's Highly Confidential Energy Risk Management Policy, dated November 10, 2009, page 11, last paragraph, states:

> ** ____
> ____
> ____
> ____
> ____________ **

Additionally, in a Highly Confidential response to Staff Data Request Number 0334, Empire provided a summary, by month, of the last five calendar years of natural gas burned breaking out by how much was hedged purchased and how much was spot purchased. Staff used the data to determine what the three- and five-year averages were, finding that Empire burned an average of 75% hedged gas and 25% non-hedged (spot purchased) gas over the last three calendar years (2007-2009), well in line with the Company's stated policy objectives. The five-year burn average was 70.6% hedged and 29.4% non-hedged gas.

Therefore, Staff does not find validity in Mr. Tarter's stated concerns about using 89% hedged in the weighting of the natural gas prices. Such a hedging rate is contrary to the Company's stated policy and its actual hedging percentage experience in recent years.

Q. Mr. Tarter also raises concerns about the coal prices used in the model, implying they should be more indicative of the pricing that is expected when rates in this case become effective. Would you care to comment?

A. Yes, I would. Staff examined all the coal contracts in place as of the end of the test year update period (December 31, 2009) in Empire's offices and noted the contractual coal prices to be in effect in 2010. These contracted prices were used by Staff as input into

Staff's fuel model. However, Staff is aware, although not specifically mentioned by Mr. Tarter, that Empire is in the process of negotiating a new rail transportation contract. To the extent such an agreement is renegotiated, and the resulting freight rates are known and measurable at the time of the true-up audit for this case, Staff intends to include the new rail costs in its updated fuel and purchased power expense. At this time, Staff is unaware of any new coal contract information that will impact Empire's overall coal costs reflected in Staff's direct filing, and Mr. Tarter does not mention any such changes in his rebuttal testimony.

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 for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	))))	Case No. ER-2010-0130

AFFIDAVIT OF KEITH D. FOSTER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Keith D. Foster, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Keith D. Foster

Subscribed and sworn to before me this 22nd day of April, 2010.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D. Suzie Mankin
Notary Public