Exhibit No.:
Issue: Iatan Disallowance, Empire's Cost
Control System
Witness: Karen L. Heady
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District Electric
Case No. ER-2011-0004
Date Testimony Prepared: April 2011

Before the Public Service Commission

of the State of Missouri

Rebuttal Testimony

of

Karen L. Heady

April 2011

Denotes Highly Confidential

REBUTTAL TESTIMONY
OF
KAREN L. HEADY
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2011-0004

1 **Q.** **PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 **A.** My name is Karen L. Heady and my business address is 602 South Joplin Avenue, Joplin,

3 MO.

4 **Q.** **BY WHOM ARE YOU EMPLOYED AND WHAT ARE YOUR DUTTIES?**

5 **A.** I am employed by The Empire District Electric Company ("Empire" or "Company") as a

6 Cost/Inventory Specialist during the Riverton Unit 12 project and a Cost Control

7 Specialist during the Asbury SCR, Iatan Unit 1 AQCS, Iatan Unit 2 and Common

8 Facilities construction and Plum Point construction projects. I served as Empire's project

9 accountant on each of these projects with the primary responsibility of monitoring,

10 tracking and providing general oversight regarding project costs, contract compliance and

11 document management.

12 **Q.** **PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL**

13 **BACKGROUND.**

14 **A.** I hold a Bachelors Degree in Accounting from Pittsburg State University and have over

15 24 years experience in accounting, contract administration and data management. I

16 began working at Empire on the Riverton Unit 12 project in 2005.

17 **Q.** **WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS CASE**

18 **BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION**

19 **("COMMISSION")?**

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1   A.   My rebuttal testimony will describe the various processes and activities comprising the cost

2   control system used by Empire to monitor and manage costs at our major construction

3   projects in response to portions of the report entitled *CONSTRUCTION AUDIT AND*

4   *PRUDENCE REVIEW – IATAN CONSTRUCTION PROJECT FOR COSTS REPORTED*

5   *AS OF OCTOBER 31, 2010* ("Staff's October 2010 Audit Report") filed herein by the

6   Commission Staff ("Staff"). More specifically, I will respond to Staff's recommendations

7   on page 3, lines 9 - 20 and again on page 22, lines 22 - 27 and page 23, lines 1 - 5, of

8   Staff's October 2010 Audit Report. The Staff recommendations are as follows:

9   • "Staff's recommended disallowances (attached as Schedule 1) are based on

10   Empire's failure to take prudent action, where such prudent action would have

11   prevented harm to Empire's ratepayers.   These instances of Empire

12   imprudence can be divided, generally, into two categories:

13   A. Empire's imprudence in failing to engage in activity to prevent from

14   inclusion in the Iatan Project costs that are unreasonable, imprudent,

15   inappropriate, or not of benefit to ratepayers, and

16   B. Empire's imprudence in failing to engage in activity such that there

17   was not a cost control system developed and in place that identifies and

18   explains any cost overruns above the definitive estimate during the

19   construction period of Iatan 2 and the environmental enhancements at Iatan 1.

20   Q.   **WHICH OF EMPIRE'S MAJOR CONSTRUCTION PROJECTS HAVE**

21   **UTILIZED THE CONTROL PROCESS YOU WILL DESCRIBE?**

22   A.   The major construction projects employing our project control process include the

23   Riverton Unit 12 and Asbury SCR construction. Each of these projects were entirely

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1   owned and managed by Empire. In addition, Empire has employed its project control

2   process on projects in which it was a partial owner such as the Iatan 1 AQCS, Iatan 2 and

3   Common construction, and Plum Point construction. These projects encompass all of the

4   projects on which I have been the leading cost control accountant on during my tenure at

5   Empire.

6   Q.   **ARE THERE DIFFERENCES IN THE APPROACHES UTILIZED BY EMPIRE**

7   **FOR EMPIRE-OWNED AND JOINTLY-OWNED PROJECTS?**

8   A.   Fundamentally, there are no differences in Empire's approach to project management,

9   whether wholly-owned or jointly owned. With each project the common objectives are

10   the same -- to effectively provide oversight with regard to project costs while providing a

11   basis for tracking and reporting costs in addition to identification and remediation of risk

12   related to project cost. With jointly owned projects, such as Plum Point and Iatan, the

13   methodologies are the same but the tasks are generally more complicated because Empire

14   cannot utilize its own internal accounting systems to gather and track project data to the

15   degree it can with a wholly owned project. Furthermore, the process of identifying,

16   tracking, and monitoring is complicated by the need to have processes in place to track

17   the communication of issues between multiple project owners as opposed to the internal

18   communications that take place on a wholly-owned project. Thus, the Plum Point and

19   Iatan projects required the development of tools that emulate the tracking and control

20   functions that are present in Empire's own accounting, budgeting, and procurement

21   systems.

22 Q.   **PLEASE DESCRIBE, IN GENERAL, THE PROCESSES THAT EMPIRE USES**

23   **TO MANAGE PROJECT COSTS ON MAJOR CONSTRUCTION PROJECTS.**

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1   A.   The first step in the process is the establishment of the project budget. All project costs

2   are tracked against the budget on a monthly, yearly, and project-to-date basis. Project

3   budgets are designed to categorize costs in a manner that facilitates project oversight and

4   reporting. Budget detail would include items such as contract payments, professional

5   services, labor, overhead, materials, travel, equipment procurement, etc.

6   Q.   **WHAT IS THE NEXT STEP?**

7   A.   The second step in the process involves a thorough review of all costs incurred against

8   the project budget for each accounting period. This includes the review of each invoice

9   for accuracy, completeness, and appropriateness. Project costs incurred are also

10   reviewed, as part of a contract fulfillment process, for compliance with contract terms.

11   The terms reviewed include items such as milestone verification or percent of completion

12   achievement and any provisions dealing with the withholding of retentions.

13   Q.   **IS THERE A THIRD STEP?**

14   A.   Yes. The third step in the process involves the maintenance of cost and other project-

15   related records in such a way that it facilitates the accurate reporting of project costs and

16   data and promotes continuing project oversight. This involves the development of

17   comprehensive record keeping system beyond Empire's typical accounting and document

18   retention procedures to provide an independent, but reconcilable, set of records

19   specifically for the project.

20   Lastly, the project cost control system and processes put in place are regularly monitored

21   by Empire's internal audit staff to ensure the system and processes involved are robust

22   and effective in design, processes and outcomes. The project cost system and processes

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1   used for Plum Point were modeled after those that Empire developed for the Iatan

2   projects and have likewise been subjected to internal audit scrutiny.

3 Q. **PLEASE ELABORATE ON THE DIFFERENCE IN PROCESSES AND TOOLS**

4   **UTILIZED BY EMPIRE TO PROVIDE COST OVERSIGHT FOR THE TWO**

5   **RECENT JOINTLY-OWNED PROJECTS VERSUS THE EMPIRE-OWNED**

6   **PROJECTS.**

7 A. The cost control systems utilized for the Iatan and Plum Point construction projects, as

8   mentioned previously, needed to emulate controls that would have been in place had

9   Empire been constructing these projects on its own. These controls include such

10   processes as verification of invoices against purchase orders, cost comparisons to budget,

11   contract compliance, and avoidance of duplication. The developed system also provided

12   the means to readily track, analyze and report project cost details.

13   Additionally, oversight was required to ensure that the participant or joint-owner billings

14   were in compliance with the terms of the contracts between the owners. To facilitate this

15   process; Empire designed and utilized a database system for each jointly-owned project.

16   The database allowed Empire to readily account for, identify, and analyze every

17   transaction; provided a means of documentation; and facilitated the communication of

18   inquires regarding cost between Empire and the management staff of each project.

19 Q. **PLEASE DESCRIBE IN DETAIL THE COST CONTROL SYSTEMS**

20   **DEVELOPED AND UTILIZED BY EMPIRE ON THE IATAN PROJECTS.**

21 A. Many of the processes utilized on the Iatan projects were of a cyclical nature, that is, they

22   corresponded to the receipt of the regular monthly invoices for construction costs. For

23   each accounting period, Empire was billed or invoiced for its portion of the construction

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1   costs for the project. For Iatan Unit 1 AQCS and Iatan Common Facilities, Empire was

2   billed for the actual costs incurred during an accounting period. For Iatan 2, the billing

3   process was different. The construction invoice for the accounting period included a

4   true-up of costs for the same period against a cash advance for estimated expenses that

5   had been billed in the preceding accounting period, per the terms of the contract between

6   Empire and Kansas City Power & Light Company ("KCPL"). At or near the same time,

7   the KCPL Comprehensive Energy Plan ("CEP") accounting staff also provided Empire

8   with cost reconciliation worksheets that summarized the costs for each project category;

9   Unit 1, Unit 2 or Common Facilities. Also included in this package were spreadsheets

10   that listed the accounts payable ("AP") vouchers with full accounting detail, electronic

11   copies of each of those vouchers, and journal-level detail for transactions during the

12   period that occurred outside of the AP system. These included items such as inventory

13   transactions for materials and supplies consumed, company vehicle usage transactions,

14   employee expense reimbursements, other travel expenditures, Missouri use taxes paid,

15   KCPL procurement card transactions, KCPL labor, loadings related to KCPL labor, labor

16   hours data, cash receipts, common transfers, miscellaneous journal entries, and other non-

17   voucher cost transactions.

18   **Q.   WHAT WAS DONE WITH THE DATA?**

19   A.   This data was loaded into Empire's database application, which made possible a

20   comparison of the cost detail for an accounting period with the invoices received from

21   KCPL for that same period. Reconciliation of this detail ensured that all billed amounts

22   were supported by either AP voucher, labor and loadings records, or other documentary

23   and explanatory evidence of the costs incurred. This reconciliation process served as

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1   support of the KCPL cost incurred and was required by Empire's management before the

2   KCPL Iatan invoices were approved for payment.

3   In addition to the data provided to Empire directly, Empire was granted access to parts of

4   the Iatan project's SharePoint site maintained by KCPL, which Empire regularly used to

5   gather additional project data and documents, such as purchase order and change order

6   information, vendor contracts, and contractor progress reports, all of which became an

7   integral part of Empire's cost control system and cost database.

8   **Q.**   **HOW DID EMPIRE USE THIS INFORMATION TO MONITOR THE IATAN**

9   **PROJECT?**

10   **A.**   Once the Iatan cost data had been assembled, reconciled, and determined to be complete,

11   a more thorough examination could be made of each individual transaction. Again,

12   Empire's database tool facilitated this activity by allowing for rapid access to both the

13   transaction detailed data and the documents supporting the transaction, such as a vendor's

14   invoice.

15   **Q.**   **HOW WERE INDIVIDUAL IATAN TRANSACTIONS REVIEWED?**

16   **A.**   The review of individual cost transactions included ensuring that the cost was related to

17   the Iatan construction project, validating the accuracy of invoice calculations, the

18   matching of vendor invoice amounts against amounts billed to Empire, and reviewing

19   invoices against prior transactions for possible duplication.

20   **Q.**   **DID EMPIRE'S REVIEW OF INDIVIDUAL TRANSACTION DETAIL RESULT**

21   **IN FURTHER QUESTIONS TO KCPL?**

22   **A.**   Yes. Examples of Empire's transaction review that would trigger additional follow-up

23   with KCPL, and potentially a request to KCPL for audit reconsideration or additional

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1   documentation, included, but were not limited to, the following: 1) the invoice is

2   incomplete; 2) invoice is missing; 3) invoice is not in compliance with vendor contract

3   payment terms; 4) invoice is not in compliance with vendor contract regarding retention

4   terms; 5) the transaction is not in compliance with Joint Owners Agreement between

5   KCPL and Empire; 6) the invoice or transaction does not clearly describe the materials or

6   services being purchased; 7) the invoice or transaction references other KCPL

7   construction projects or generating units; 8) the invoice or transaction does not

8   specifically reference the Iatan construction projects; 9) the invoice is not supported by a

9   purchase order on SharePoint; 10) the project ID is inappropriate; 11) the purchase order

10   reference is missing or inappropriate; 12) the invoice amount does not reconcile to the

11   amount paid; 13) an excessive delay in invoice payment; 14) the invoice is not supported

12   by vendor documentation; 15) sales tax payment or omission errors; 16) sales tax

13   calculation errors; 17) payments made in excess of purchase order limits; 18) the

14   transaction is not subject to capitalization in accordance with FERC and GAAP

15   guidelines; 19) the transaction is outside the scope of the vendor contract; and, 20) the

16   transaction is outside the scope of construction budget.

17 **Q.** **DID THE EMPIRE DATABASE USED TO MONITOR THE PROJECT**

18   **IMPROVE COMMUNICATIONS BETWEEN EMPIRE AND KCPL**

19   **CONCERNING THE IATAN PROJECT?**

20 **A.** Yes. The cost database applications developed and utilized by Empire included tools that

21   facilitated communications between Empire and KCPL regarding requests for additional

22   information, documentation, audit, or other reconsideration of certain items included in

23   the construction cost invoices from KCPL. Transactions were tagged with a number,

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1   date, status, and information request and then were included in formal reports that Empire

2   issued to KCPL. KCPL then responded by request number, which would put Empire in a

3   position to monitor each of KCPL's responses. KCPL responses were also tracked in the

4   database allowing for periodic follow-up when necessary.

5   Empire also used the database application to accurately assess and record its ongoing

6   liability for contractor retention for the projects.

7   **Q.   WERE THE PROJECT MANAGEMENT TOOLS UTILIZED BY EMPIRE ON**

8   **THE IATAN PROJECT RESTRICTED TO REVIEWING PROJECT COSTS?**

9   A.   No. To supplement the process of cost review through the database application, a

10   Request for Information ("RFI") process in cooperation with KCPL was developed

11   independently as a separate tool to communicate and track requests for information to

12   KCPL that were not specifically related to the cost of a transaction, but were more

13   general in nature. This supplemental process grew out of the need of both Empire and

14   KCPL to document and track requests and responses to project management issues,

15   which were beyond the scope of the established audit and document request processes.

16   KCPL adopted the RFI procedure for use with the other Joint Owners.

17   **Q.   HOW DID EMPIRE'S ACCESS TO SHAREPOINT ASSIST EMPIRE IN ITS**

18   **INVOLVEMENT WITH THE IATAN PROJECT?**

19   A.   Empire's access to SharePoint enabled regular review of contractor change orders,

20   correspondence, reforecast data and other documents that were instrumental in directing

21   Empire management's attention to project matters for follow-up with KCPL's project

22   management directly, at Joint Owners meetings or with a formal RFI.

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1 Q. **CAN YOU DEMONSTRATE THE EFFECTIVENESS OF EMPIRE'S COST**

2 **CONTROL SYSTEMS WITH REGARD TO THE IATAN PROJECTS?**

3 A. Yes. There are a number of indicators as to the effectiveness of Empire's systems and

4 processes.

5 1) To date, Empire has been able to review 86% of the 37,010 transactions reported by

6 KCPL for the Iatan projects, representing 87% of the total costs of the projects.

7 2) To date, Empire has been able to identify and account for 99.998% of the costs billed

8 by KCPL as Empire's share of the project costs.

9 3) To date, Empire has initiated 830 formal requests for audit reconsideration or

10 documentation covering more than 1,600 transactions, or about 5% of the transactions

11 reviewed.

12 4) To date, Empire has initiated 58 RFIs (Requests for Information) and has received

13 responses to 52 of those requests.

14 5) As detailed in Schedule KLH-1, Empire has appropriately identified

15 ****_____**** to date in total project costs that were deemed improperly billed to

16 Empire as a result of its review process. Empire's share of that amount is

17 ****_____****.

18 Q. **WHAT WAS DONE WITH THE AMOUNT IDENTIFIED IN PART 5)**

19 ****_____** OF THE PRECEEDING QUESTION?**

20 A. Empire's construction cost for the Iatan projects has been reduced by that amount.

21 Q. **HAS THE STAFF RECONGIZED THIS REDUCTION IN ITS AUDIT?**

22 A. Based on the level of detail supplied in Staff's audit, it cannot be determined, but a

23 reduction was not specifically mentioned.

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1   **Q.**   **DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

2   A.   Yes, it does.

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AFFIDAVIT OF KAREN L. HEADY

STATE OF MISSOURI   )
) ss
COUNTY OF JASPER   )

On the __12th__ day of April, 2011, before me appeared Karen L. Heady, to me personally known, who, being by me first duly sworn, states that she is the Assistant Manage Property Accounting of The Empire District Electric Company and acknowledges that she has read the above and foregoing document and believes that the statements therein are true and correct to the best of her information, knowledge and belief.

_____
Karen L. Heady

Subscribed and sworn to before me this __12th__ day of April, 2011.

JULIA L BLACKBURN
Notary Public - Notary Seal
State of Missouri
Commissioned for Newton County
My Commission Expires: August 26, 2011
Commission Number: 07216221

_____
Notary Public

My commission expires: __8 - 26 - 11__ .