Exhibit No.:	
Issues:	*Riverton Unit 12 O&M and Tracker, Incentive Compensation*
Witness:	*Jermaine Green*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*ER-2016-0023*
Date Testimony Prepared:	*May 16, 2016*

MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

AUDITING DEPARMENT

SURREBUTTAL TESTIMONY

OF

JERMAINE GREEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2016-0023

Jefferson City, Missouri
May 2016

TABLE OF CONTENTS OF

SURREBUTTAL TESTIMONY

OF

JERMAINE GREEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2016-0023

SURREBUTTAL TESTIMONY

OF

JERMAINE GREEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2014-0351

Q. Please state your name and business address.

A. Jermaine Green, Governor Office Building, P.O. Box 360, Jefferson City, Missouri 65102.

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

A. I am a Utility Regulatory Auditor with the Missouri Public Service Commission ("Commission").

Q. Are you the same Jermaine Green who has previously contributed to the Commission Staff's ("Staff") *Cost-of-Service Report – Revenue Requirement Report* ("Report") dated March 25, 2016 for The Empire District Electric Company ("Empire" or "Company")?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony addresses the rebuttal testimonies of Empire witnesses Brad P. Beecher, regarding the Company's incentive compensation expense; and John M. Woods, regarding Riverton operations and maintenance ("O&M") expense and the Riverton Unit 12 O&M tracker.

EXECUTIVE SUMMARY

Q. Please briefly summarize your surrebuttal testimony pertaining to this rate case.

A. In this testimony, I will first address the issue of O&M expenses and Empire's proposed adjustment in determining its normalized O&M expenses for it Riverton Power Plant. It is Staff's position that the normalized expense for this combined cycle unit be adjusted using historical O&M cost figures from another Empire generating unit, the State Line Combined Cycle ("SLCC") unit.

Next, I will explain Staff's recommendation regarding the Company's proposed Riverton Unit 12 O&M tracker "base level." Staff is proposing a different expense level be used as the base amount for this tracker than that advocated by Empire.

Lastly, I will address Staff's position regarding incentive compensation expenses for 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) long-term equity incentive compensation to executives, and (3) "Lightning Bolts" for short-term discretionary incentive compensation to non-management employees. Staff does not object to Empire's practice of offering its employees variable compensation based on the attainment of certain goals. However, Staff recommends that, for this expense to be allowed in rates, incentive compensation for all employees should be based on goals that provide a direct benefit to ratepayers, not goals which have a primary purpose of benefiting shareholders.

<u>RIVERTON OPERATIONS AND MAINTENANCE EXPENSE</u>

Q. Have there been any modifications to Staff's position since its direct filing as it relates to Riverton Unit 12 normalized O&M Expense in this case?

A. Yes. After discussions with the Company, Staff has modified its filed position in direct testimony in which a five-year historical average of prior Riverton Station O&M expenses were used to determine the normalized maintenance costs for the Riverton generating facility. Instead, Staff will adopt the Company's proposed adjustment based on projections for a combined cycle unit operation using the SLCC historical O&M costs. The dollar amount of this adjustment will not be determined until after Staff reviews additional work papers that the Company has committed to providing.

Q. Why does Staff typically analyze five years of data for O&M expense for purposes of normalization, and what is the justification for changing this methodology in regard to Riverton Unit 12?

A. Staff normally uses an averaging technique to set rates for generation O&M normalization purposes for many years in many different rate cases, and will likely continue to do so in the future. Staff still believes a multi-year average, such as a five-year average, is a reasonable approach because it uses actual expense incurred and eliminates the impact of annual fluctuations in these expenses. However, Staff believes in this case an exception to the five-year historical average should be made as it relates to the Riverton generating facility, due to the many operational changes that have occurred at the Riverton station in the last five years. First, Riverton Unit 12 has been converted from a simple cycle unit to a combined cycle unit that became operational May 1, 2016. Also, Riverton Units 7 and 8 were recently retired. Therefore, it is expected that all of these changes will cause the ongoing level of O&M costs for Riverton to significantly change. For this reason, including the historical five-year normalized average O&M costs for the Riverton Units would not be appropriate in these circumstances.

Q. How does this change impact the ongoing level of Riverton O&M expenses?

A. The ongoing level of O&M expense for Riverton is expected to increase by $823,269 from the level in Staff's direct filing. As stated earlier, Staff will update the adjustment to its direct filing once the additional information used by the Company in determining this proposed ongoing normalized expense is provided to Staff.

RIVERTON UNIT 12 O&M TRACKER BASE COST

Q. What is Staff's recommendation concerning the Company's proposed Riverton Unit 12 O&M tracker base?

A. It is Staff's position that the tracker base level should remain at $2.7 million for costs associated with the Long-Term Maintenance Contract with Siemens Instrumentation, Controls and Electrical Group ("Siemens Contract") instead of the $3.9 million as proposed by the Company, until there is sufficient operational history to determine if a rebase is appropriate. Furthermore, after discussions with the Company, it is also now Staff's position to expand the accounts included in the tracker to account for the additional O&M costs associated with Riverton Unit 12 that fall outside of the Siemens Contract. As discussed above this amount is approximately $823,269.

Q. Please explain Staff's methodology in determining the amount for the tracker base.

A. The costs payable under the Siemens Contract are based in part on the amount of equivalent operating hours ("EOH") incurred by the Riverton 12 unit. Staff's methodology for determining the Riverton Unit 12 tracker base of $2.7 million was based on EOH estimates provided by the Company in Rate Case No. ER-2014-0351, with the exception of 2,475 EOH's that the Company proposed for the commissioning of the new Riverton 12 unit as a combined cycle generation unit. It was Staff's position in that case that the 2,475 hours represent a one-time cost and should not be included in ongoing expense levels or in a tracker mechanism. The base amount of $2.7 million Missouri Jurisdictional for the Riverton Unit 12 tracker was agreed to in Empire's last general rate case, No. ER-2014-0351, as part of the *Non-Unanimous Stipulation and Agreement*.

Q. Do you agree with Empire's methodology in calculating its Riverton Unit 12 tracker base in this proceeding?

A. No. Staff believes the estimated EOHs agreed to in Rate Case No. ER-2014-0351 to determine the base is appropriate, instead of the current base proposed by the Company. Furthermore, in his rebuttal testimony on page 4, lines 11 and 12, Mr. Woods states "Empire freely admits that its projected expenses for the unit are educated estimates, and may be wrong – such is the reality for any forecast." Therefore, until Riverton Unit 12 has sufficient historical O&M expense data for analysis, a rebase to $3.9 million Missouri Jurisdictional is not appropriate at this time.

Q. Will Empire be harmed if Staff's recommended tracker base of $2.7 million is used to set rates instead of the Company's recommendation of $3.9 million?

A. No. A tracker is a two-way regulatory mechanism that provides for the recording of a regulatory liability when the Company spends less than the targeted base amount and the recording of a regulatory asset when the opposite occurs. This mechanism has potential benefits for both the Company and its ratepayers. A tracker helps to ensure that neither the Company nor its customers will experience a windfall as a result of changes in the O&M level of expenses. As a result, the tracker base of $2.7 million will not adversely impact the long-term ability of the Company to recover the new level of O&M expenses associated with operation of Riverton Unit 12 as a combined cycle unit.

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 for Empire executives and department heads as well as the long-term incentives. Staff did not adjust the Empire executives' base salaries in its direct case.

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

A. On page 3, lines 12 to 17, of Mr. Beecher's rebuttal testimony, he states:

> Empire's approach is comparable, by incorporating a mix of base salary, short-term incentives, 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 aligns employee performance with the interests of customers and shareholders.[1]

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

---

[1] Emphasis in original.

A. Staff agrees with Mr. Beecher's statement that companies in the utility industry typically include a mix of base salary, short-term and long-term incentives into their total executive compensation package. However, as it regards to Missouri regulated utilities, Staff has consistently 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 pages 3 through 4, Mr. Beecher attempts to justify rate recovery for Empire's executive incentive compensation expenses on the grounds that Empire's total compensation package for its executives is lower than that of the peer group. Please respond.

A. Mr. Beecher 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 proposes that 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 which do not result in real improvement in utility performance. Whether a utility pays high or low total compensation levels should not affect this fundamental concern.

Q. Mr. Beecher 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 have 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.

Q. Please explain Staff's calculation of allowable MIP in this case.

A. In order to determine the appropriate amount to include for the MIP in this case, Staff performed a review of all the incentive metrics used to measure each individual goal and disallowed all the actual payouts to Empire executives and department heads associated with performance measures tied to meeting financial goals; i.e. "earnings per share" targets. It is Staff's position that any incentive goals associated with enhancing the value of a utility's stock price and the achievement of these goals is a benefit to Empire's shareholders, and not Empire's ratepayers.

Q. On page 4 of his testimony, Mr. Beecher references specific adjustments that Staff made to disallow a portion of the executive incentive compensation and made the statement that these adjustments are unreasonable. Please comment.

A. Mr. Beecher makes the statement that Staff's adjustments are unreasonable because Empire's total target compensation is set at the 25th percentile of a comparable industry peer group and the awards are only payable to an executive officer if they perform above the "minimum" or "threshold" levels of performance. Mr. Beecher doesn't take into account what each specific goal pertains to. Mr. Beecher appears to take a position 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 reasoning and believes that each individual goal should be scrutinized to determine if it has a direct benefit to ratepayers. Staff reviewed all of the specific goals for Empire's executives in this case and it is Staff's position to disallow only those awards given to executives and department heads that do not have a direct benefit to ratepayers.

As had been customary in past rate cases, Staff's policy is still to allow incentives related to customer service, reliability and safety, and environmental compliance. These goals are associated with the provision of safe, adequate and reliable service to the ratepayers.

Q. Mr. Beecher is in his rebuttal testimony alludes to Empire's Total Compensation being in the 25th percentile and is, therefore, more conservative as compared to the peer group. How does Staff respond?

A. Staff's review of the similar sized utilities that are used in the peer group study reveal that 55% of the companies were based in western and eastern states of the United States; areas that are understood to command higher levels of compensation due to the higher cost of living. Therefore, it stands to reason that any comparison of Empire's total compensation would inherently show lower results when compared to compensation levels of utility companies operating in larger metropolitan cities in other areas of the country. In short, Empire's rank of the 25th percentile is not necessarily a fair comparison when considering economic conditions in Joplin, Missouri to larger cities. As stated earlier, Staff is not proposing its adjustments to Empire's incentive compensation expense on the grounds that Empire's incentive compensation is 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 which do not result in any real benefit to the ratepayers.

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

A. Yes, in several instances. In the *Report and Order* issued in Case No. GR-96-285, Missouri Gas Energy ("MGE"), the Commission stated the following regarding the issue of incentive compensation plans that used 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 also addressed this issue 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 KCPL rate cases.

<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. Beecher's rebuttal testimony at page 8, lines 6 to 8, that "Staff excluded a portion of the non-executives that was associated with goals that Staff believed benefited shareholders and not customers."?

A. Yes, this is correct. Similarly to the MIP as discussed above, in order to determine the appropriate amount to include for the Department Head Cash Incentive Plan in this case, Staff performed a review of all the incentive metrics used to measure each individual goal and disallowed all the actual awards paid out to Empire's department heads associated with performance measures tied to enhancing the value of the utility's stock price; i.e., earnings per share.

Lightning Bolts

Q. Did Staff propose to disallow the expense associated with Empire's "Lightning Bolt" awards?

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

Q. What is the reason for Staff's disallowance of Lightning Bolts?

A. Mr. Beecher states the Lightning Bolt Program provides cash awards to individuals who deliver results beyond those normally associated with their position. However, Lightning Bolts do not have any pre-set goals or objectives attached to them that employees can "work toward," and are paid out at the senior management's discretion.

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

A. The Commission stated its position on this matter in its *Report and Order*, page 49, in Empire's prior rate, Case No. ER-2006-0315:

> 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.

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's Request for Authority to Implement a General Rate Increase for Electric Service	)))	Case No. ER-2016-0023

AFFIDAVIT OF JERMAINE GREEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW JERMAINE GREEN and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing SURREBUTTAL TESTIMONY; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

JGreen

JERMAINE GREEN

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 16th day of May, 2016.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin

Notary Public