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Witness: Dale W. Harrington
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Case No. ER-2008-0093
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Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Dale W. Harrington

April 2008

REBUTTAL TESTIMONY
OF
DALE W. HARRINGTON
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2008-0093

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Dale W. Harrington, 602 Joplin Avenue, Joplin, MO 64801.

Q. WHO IS YOUR EMPLOYER AND WHAT POSITION DO YOU HOLD?

A. My employer is The Empire District Electric Company ("Empire" or "Company"). I hold the position of Assistant Director of Human Resources.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. I hold a Bachelor of Science Degree in Business Administration with a major in Accounting from Missouri Southern State University in Joplin, Missouri.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE.

A. Prior to joining Empire, I worked for a large national roofing manufacturing company. I joined Empire in 1989 as an internal auditor. I have held positions in Internal Auditing, Financial and Regulatory Accounting, and Human Resources. I left Empire in 2001 to join a nationwide trucking company. I rejoined Empire in 2002 and have worked there continuously since.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have prepared this rebuttal testimony to respond to the Missouri Public Service Commission Staff ("Staff") recommendation to exclude a significant portion of Empire's ongoing compensation levels from the cost of service in this case. My testimony will explain how Empire's executive compensation program is designed and how Empire's approach is similar to the approach utilized by companies that are comparable to Empire. Further, I will explain how the overall executive compensation program in place at Empire is reasonable and quite conservative when compared to our peers within the industry, and why Staff should include all components of executive compensation in Empire's test year expense. Lastly, I will explain Empire's incentive compensation approach for non-executive salaried employees and how certain amounts that Staff has recommended be excluded from test year expense should properly be included.

Q. HOW IS THE EXECUTIVE COMPENSATION PROGRAM AT EMPIRE DESIGNED?

A. Empire's executive compensation program is designed to provide a competitive compensation package that will enable us to attract and retain highly talented individuals for key positions and promote the accomplishment of our performance objectives. Our overall compensation program is conservative when compared to our peers. It provides a secure base salary with the opportunity to earn a higher level of total compensation under incentive programs that link compensation to individual and Company performance factors.

Our executive compensation program includes three basic compensation elements: (1) base salary, (2) annual (short-term) cash incentives, and (3) long-term incentives. The Compensation Committee of the Board of Directors ("Compensation Committee") has established a compensation philosophy that targets a certain level of compensation based on a national market survey developed by a compensation consultant employed by the Compensation Committee. Once certain benchmark compensation levels are determined, the Compensation Committee compares the dollar values resulting from the benchmarking process to corresponding compensation levels at an industry-specific peer group ("peer group") of companies to ensure that total direct compensation is competitive within the industry and appropriate when certain levels of performance are achieved. The peer group developed by the compensation consultant is similar to Empire in terms of revenue, market value, growth, etc.

Q. HOW DOES EMPIRE'S EXECUTIVE COMPENSATION APPROACH COMPARE TO SIMILAR COMPANIES?

A. Companies similar to Empire typically utilize the same approach by incorporating a mix of base salary, short-term, and long-term incentives into a total executive compensation package. Rather than relying solely on fixed compensation in the form of base salary, these companies also include a considerable measure of variable (at risk) compensation in their total compensation package. This approach is considered a best practice in executive compensation and 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. ACCORDING TO YOUR UNDERSTANDING HOW DOES EMPIRE'S EXECUTIVE COMPENSATION PHILOSOPHY COMPARE WITH THE COMPENSATION PHILOSOPHY OF OTHER COMPANIES?

A. While Empire's approach to executive compensation is similar to other companies, the Company's philosophy behind the approach is much more conservative. In terms of **base salary**, the Compensation Committee has targeted the 25^{th} percentile of the national market survey discussed above for similarly situated executives. In so doing, the Compensation Committee has set target base salary levels **significantly lower** than the target base salary levels of the comparator companies and industry in general. As indicated by the accompanying Schedule DWH-1 (developed through analysis of the executive compensation section of the most recently available proxy statements), the average target base salary level of the comparator companies was set at the 50^{th} percentile of the market, compared to Empire's use of the 25^{th} percentile.

The Compensation Committee has also established **short- and long-term incentive** target levels for Empire executives that are **below** those of the comparator companies. For example, the target levels for short- and long-term incentives utilized by Empire are set at approximately the **43^{rd} and 44^{th}** percentiles, respectively, compared to the comparator companies' averages for short- and long-term incentives target levels of the 53^{rd} and 52^{nd} percentiles, respectively. Furthermore, the target levels utilized for short- and long-term incentives by the comparator companies ranged from the 50th percentile to the 75th percentile.

In terms of **total compensation**, the Compensation Committee has set a target level for Empire executives at approximately the **37.5th** percentile. This is substantially lower than the average total compensation target level of the comparator companies, which is in **excess of the 50th** percentile. In addition, target levels for total compensation ranged from the 50th percentile to the 60th percentile in the comparator companies.

Q. HOW DOES EMPIRE'S EXECUTIVE COMPENSATION PHILOSOPHY IMPACT COMPENSATION AWARDS AS COMPARED TO THE COMPARATOR COMPANIES?

A. Because of Empire's conservative compensation philosophy, overall compensation awards are significantly less than similar awards of the comparator companies. As indicated by the table, the base salary of Empire's CEO is 43% below the comparator company average of CEO base salary. The stock compensation and non-equity incentive compensation awarded to Empire's CEO are 56% and 61% below the comparator company averages, respectively. Finally, total compensation awarded to Empire's CEO, as reported under the Security and Exchange Commission's proxy statement regulations, is 50% below average total compensation awarded to comparator company CEO's.

The same observation can be made with regard to average compensation paid to other named executive officers ("NEOs"). The average base salary of Empire's NEO's, other than the CEO, is 39% below the comparator company average. The average award to Empire's other NEOs for stock awards, non-equity incentive compensation and total compensation is 77%, 68% and 59% below similar awards to all other NEOs of the comparator companies, respectively.

Q. WHAT ADJUSTMENTS DID THE STAFF'S WITNESS MS. PAULA MAPEKA MAKE TO EXECUTIVE COMPENSATION?

A. Ms. Mapeka recommended the removal of several components of Empire's total compensation package from test year expense, namely those that constitute the variable or at risk compensation. More specifically, the Staff has recommended removal of compensation associated with performance measures under the annual cash incentive plan related to meetings with institutional investors, issuances of debt and equity, reliability measures at the Company's State Line Combined Cycle generating station, jurisdictional approval of the Southwest Power Pool Regional Transmission Organization, and the completion of an Automated Meter Reading development study and pilot program.

Q. HOW DO YOU RESPOND?

A. The compensation expense associated with these performance measures is properly includable in cost of service. In addition, the Staff has recommended removal of the full amount of the compensation associated with the long-term incentive award. Combined, these recommended adjustments would remove

$482,395 from test year expense. For reasons I will discuss below, these expenses should be included in test year expense.

Q. DO YOU AGREE WITH THE STAFF'S RECOMMENDATION TO REMOVE SUCH FORMS OF VARIABLE OR AT RISK COMPENSATION FROM TEST YEAR EXPENSE?

A. No. The elimination of the variable or at risk compensation includes the incorrect assumption that such awards are not part of the total compensation package, but in addition to the total compensation package developed by Empire and constitute additional compensation without a corresponding benefit to Empire and Empire's customers. Each component of variable compensation is essential to complete the executive's total compensation package. Variable compensation is at risk and standards in the form of performance criteria are necessary in order to determine what portion of the compensation is earned by Empire's employees. The Compensation Committee has developed such performance criteria as a function of placing a substantial portion of an executive's total compensation in variable rather than fixed vehicles in order to encourage high levels of performance. This approach is consistent with the approach utilized by the comparator companies and industry in general.

Q. WHAT IS THE CONSEQUENCE OF FOLLOWING STAFF'S RECOMMENDED ADJUSTMENTS TO EXECUTIVE COMPENSATION?

A. It tends to undermine the overall objectives of Empire's Compensation Committee by shifting more of the emphasis to base compensation to ensure cost recovery. The performance criteria determined by the Compensation Committee for each executive are tied to the Company's vision, goals and key business strategies established at the beginning of each performance year. Such performance criteria are different than those that might be determined for other non-executive employees. These performance criteria form the core of each executive's responsibility and are not simply accomplishments that are above regular job duties. Accomplishment of executive performance criteria has a significant positive impact on the operational and financial condition of the Company. Conversely, non-accomplishment of such performance criteria has a negative impact on the Company. The degree, or lack thereof, of accomplishment is reflected in the variable nature of the associated compensation award.

To follow Staff's recommended adjustment and remove the variable compensation expense related to short- and long-term components of the executive compensation package from test year expense does not recognize the compensation awarded the executive for accomplishment of the core responsibilities of their position and the benefits those accomplishments bring to Empire and its electric customers. Therefore, all elements of executive compensation should properly be included in test year expense.

Q. HOW DOES EMPIRE APPROACH COMPENSATION WHEN IT INVOLVES ITS NON-EXECUTIVE SALARIED EMPLOYEES AND HOW DOES THAT APPROACH COMPARE WITH BEST PRACTICES IN THE COMPENSATION FIELD?

A. Empire follows best practices in compensation structure for its non-executive salaried employees by linking its performance management systems with how employees are paid. This is achieved by allocating a percentage or fixed amount of an employee's compensation to a variable pay program tied directly to the attainment of goals and objectives set forth by management and aligned with Empire's overall vision, goals and key business strategies. These goals and objectives are above the regularly expected results of the non-executive salaried employee's position, and, when achieved, add benefit not only to the Company but its customers as well.

Q. DID THE STAFF PROPOSE ADJUSTMENTS TO NON-EXECUTIVE SALARIED COMPENSATION EXPENSE FOR THE TEST YEAR?

A. Yes. The Staff recommended removal of $273,176.67, or nearly 43%, of the expense related to non-executive incentive compensation. Ms. Mapeka developed this amount by sampling non-executive salaried employee performance evaluations. Ms. Mapeka made a judgment as to what percentage of the total number of incentive goals identified from the sample were not cost of service related, then applied this percentage to the total test-year non-executive salaried incentive compensation expense to arrive at an amount to exclude from test year expense.

Q. DO YOU AGREE WITH THE STAFF'S APPROACH TO THIS ISSUE OR THE STAFF'S RECOMMENDATION?

A. No, I do not. In an effort to determine a percentage of non-executive salaried incentive compensation expense to disallow from Empire's cost-of-service, Ms.

Mapeka inappropriately used some specific incentive goals and then projected their impact over the entire non-executive salaried population. For instance, Ms. Mapeka's sample employees included two employees who deal almost exclusively with shareholder issues, which were categorized by Staff as non-recoverable from customers. However, these particular incentive goals are exclusive to these two individuals and should not be projected over the entire population of salaried employees. In addition, Ms. Mapeka incorrectly projected a number of incentive goals that were not achieved over the entire non-executive salaried population. By design, the non-executive salaried employee incentive approach eliminates any compensation for incentive goals that were not achieved. Thus, there was no compensation included in the test year associated with non-achieved incentive goals. The Staff's incorrect proposed adjustment would penalize the Company for an expense that didn't occur.

Q. PLEASE QUANTIFY THE IMPACT OF THE STAFF'S INCORRECT PROPOSED ADJUSTMENT.

A. Approximately 46% of the incentive goals included in Ms. Mapeka's evaluation sample were incorrectly attributed to the entire non-executive salaried employee population. This results in an inappropriate disallowance of $125,666. This amount should properly be included in test year expense.

Q. DID THE STAFF RECOMMEND ADJUSTMENTS TO ANY OTHER FORMS OF INCENTIVE COMPENSATION?

A. Yes. Ms. Mapeka recommended removal of $168,000 from test year expense related to the Company's Lightning Bolt award program. This amount represented the entire amount of compensation awarded through the program during the test year.

Q. PLEASE EXPLAIN THIS PROGRAM.

A. The Lightning Bolt program is not an incentive program. Through this program, the Company provides cash awards to individuals who deliver results beyond those normally associated with their position. In particular, the majority of the awards from the Lightning Bolt program distributed during the test year were related to ice storm recovery efforts. Many salaried employees worked extremely long and difficult hours during the storm recovery efforts answering customer calls and questions, providing logistical assistance to work crews, delivering meals, laundering work clothes, etc. In no way does the Lightning Bolt program fully compensate the non-executive salaried individual for the actual overtime they work. However, it is the only vehicle available to the Company to show appreciation to salaried individuals who do not earn overtime for working beyond their normal hours during the storm recovery. The proposed Staff disallowance in this area is most definitely related to Empire's cost of service and should properly be included in test year expense.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.