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Witness:	*Paula Mapeka*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

PAULA MAPEKA

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2008-0093

Jefferson City, Missouri
April 2008

** **Denotes Highly Confidential Information** **

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SURREBUTTAL TESTIMONY OF

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THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2008-0093

Q. Please state your name and business address.

A. Paula Mapeka, 200 Madison Street, Suite 440, Jefferson City, MO 65102.

Q. What is the purpose of this testimony?

A. I am addressing certain aspects of The Empire District Electric Company's (Empire or Company) rebuttal filing, regarding the Company's incentive compensation expense and the property taxes related to the Selective Catalytic Reduction ("SCR") project that was constructed at its Asbury Power Station.

EXECUTIVE SUMMARY

Q. Please provide a brief summary of your testimony.

A. This testimony addresses the 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: executive incentive compensation, non-management employee incentive compensation, and "Lightning Bolt" awards. The Staff does not object to Empire's practice of offering its employees variable compensation based on attainment of certain goals. However, the Staff recommends that incentive compensation for all employees should be based on goals that benefit ratepayers not goals that benefit shareholders.

This testimony also addresses why the Staff opposes inclusion of property tax expenses related to the SCR project as part of the cost of service for Empire in this case.

STAFF CHANGES – INCENTIVE COMPENSATION

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

A. Company Witness Dale W. Harrington discusses in his rebuttal testimony that the Staff had excluded compensation associated with certain performance measures from the annual cash incentive plan from Empire's executive compensation program, namely the cash incentive goals 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. After further discussion with the Company, the Staff agrees with the Company with regards to these specific criteria and has 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 short term cash incentives from ** ________ ** to ** _______ **.

Q. Are you addressing any other changes made by the Staff?

A. Yes. Mr. Harrington also points out in his rebuttal testimony that the Staff, in its sample for the incentive goal objectives for the non-executive salaried employee population, included two employees who deal almost exclusively with shareholder issues. Mr. Harrington argues that these two employees are not representative of most Empire employees in that their functions do not primarily relate to regulated cost of service, and therefore should not be included in the sample. To remove one source of contention on this issue, the Staff has eliminated these two individuals from its sample and has replaced these two individuals with most of the sample employees previously used by the Staff in Case No. ER-2006-0315, Empire's previous Missouri rate proceeding. Empire did not question the suitability of this sample in that proceeding. Therefore, the Staff believes using the ER-2006-0315 sample as a replacement for the two employees objected to by Empire would be more representative of Empire's non-management employee population. The Staff did not use the whole employee sample from Case No. ER-2006-0315 because some of the employees have been categorized as hourly employees, have resigned their positions, or the Staff had already included the same employees in its initial sample. This change to the sample reduces the amount of the Staff's proposed disallowance regarding non-management incentive compensation from ** __________ ** to ** __________ **

<u>EXECUTIVE COMPENSATION</u>

Q. Please explain the executive compensation program at Empire.

A. The executive compensation program at Empire is comprised of three basic elements: 1) base salary, 2) annual (short-term) cash incentives, and 3) long-term incentive plans (LTIP).

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

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

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

A. On page 3, lines 13 to 22, of Mr. Harrington's rebuttal testimony, he states:

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

A. The Staff is in agreement with Mr. Harrington in that most, if not all, of the investor owned utility companies in Missouri have a mix of base salary, short-term and long-term incentives built into the total executive compensation package. At many utilities, the 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 position the Staff is taking in this proceeding is no different than what has been 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 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, 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;" its 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 effect this fundamental fairness concern.

Q. Please explain Empire's LTIP.

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

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

A. The 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 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 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. What other issues did Staff disallow from the short-term cash incentive?

A. Among the objectives disallowed by the Staff were those related to the gas property acquisition transition, objectives that are related to the non-regulated business, and objectives that are related to and working on Missouri rate case filings to achieve higher rates for Empire. The Staff believes these objectives do not provide a direct benefit to electric rate payers.

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 Nos. GR-96-285 et al., 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

The Commission also 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 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 not 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.

The Commission also reiterated its position 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).

NON-EXECUTIVE SALARIED COMPENSATION

Q. In regards to the non-executive salaried employee incentive compensation, is it true as referenced in Mr. Harrington's testimony on page 9, lines 12 to 19, which the Staff disallowed ** __________ ** in expense related to this item?

A. Yes, this is correct. The Staff had taken a sample of non-executive salaried employee performance evaluation and job descriptions and had analyzed the incentive goals of these employees. After analyzing this data, the Staff used this information to arrive at an amount to exclude from test year expense by excluding amounts related to goals that the Staff believed did not contribute to the cost of service for the electric rate payers. In addition, the Staff removed incentive goals that the Staff believed fell under regular job duties and normal job performance.

Q. Has the Staff re-evaluated this adjustment?

A. Yes. The Staff made certain changes to its sample in response to the Company's rebuttal testimony that has been previously discussed in this testimony.

Q. Does Empire have any other differences with the Staff with regard to non-executive salary incentives?

A. Yes. Mr. Harrington states on page 10, lines 7 to 13, of his rebuttal testimony the following:

> 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

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> salaried employee incentive approach eliminates any 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. Does the Staff agree with this contention?

A. No. On the initial set of sample data that Staff received from Empire, there are two employees, who will be called "Employee A" and "Employee B", who received incentive compensation. Employee A did not have any incentive goals listed. For Employee B, of the four incentives that were listed, one incentive was labeled as "did not meet expectation" (DNME), and the other three of the four incentive goal projects had been postponed, so that the resources could be used for the gas integration project. It is Staff's belief that neither Employee A nor Employee B met any objectives at all, much less any that might be related to electric cost of service. However, both of these employees received incentive compensation from Empire.

Q. Did the Staff request from Empire a breakdown showing how the incentive goals were weighted for the employees whom the Staff had categorized as "did not meet expectations"?

A. Yes, the Staff requested a breakdown of the weighting of each employee's incentive compensation in Data Request No. 34.5. The Staff disallowed compensation associated with DNME goals because the Staff has not been able to verify whether the employees have been rewarded for objectives they in fact did not meet. The response to Data Request No. 34.5 that was provided by Mr. Harrington indicated the following:

> **

________________ ** [Emphasis added.]

The Staff interprets the above response provided by Mr. Harrington as showing managers have discretion to issue compensation to employees who did not meet some goals. Therefore, based upon this response, and the earlier example of "Employee A" and "Employee B", the Staff believes there are instances where employees received incentive compensation for goals they did not meet. Accordingly, the Staff did not modify its adjustment in response to Mr. Harrington's argument on Staff's treatment of non-attained goals.

<u>LIGHTNING BOLTS</u>

Q. Did the Staff disallow Empire's Lightning Bolts in the amount of ** ________ ** ?

A. Yes. The Staff disallowed the whole test year amount of lightning bolt expenses in its entirety.

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Q. Mr. Harrington identifies that the Lightning Bolts program provides cash awards to 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. Mr. Harrington also indicates that part of these lightning bolts were related to the ice storm restoration efforts. How does the Staff respond to this point?

A. The Staff acknowledges that many Empire employees made great efforts to assist in restoring service to customers after the ice storms struck. However, ice storms such as those that effected Empire's service territory in 2007 are unusual and infrequent in occurrence and the Staff considers them to be "extraordinary events." The Staff and the Commission have followed a consistent policy that costs associated from extraordinary events should not be recovered in its entirety from ratepayers; rather, the financial impact of those events should be shared between the utility and its customers. The Staff has followed this policy in this proceeding for ice storm costs not related to incentive compensation by proposing to amortize such costs over five years to expense, and not providing rate base treatment for the unamortized balance of ice storm costs. For this reason, the Staff asserts that the ** _______ ** in test year ice storm lightning bolts expenses should not be included in Empire's cost of service, since these costs do not qualify for recovery under the Commission's standard test for inclusion of incentive compensation in rates in any case.

Q. Aside from the ice storm, what other major events triggered lightning bolt awards?

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A. Empire also awarded ** _______ ** in the test year for efforts relating to the "gas integration" project. In 2006, Empire purchased Aquila's natural gas segment. In so doing, Empire had to integrate the gas segment with the rest of Empire's corporate operations. The Staff believes that this gas integration project does not provide any direct benefit to the electric customers and should not be included in the electric cost of service.

Other than the Lightning Bolt awards associated with ice storm recovery and gas integration activities, the Staff also disallowed the remaining ** _______ ** of test year Lightning Bolts because the payouts for these amounts were associated with the performance of regular job duties.

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. (emphasis added)

PROPERTY TAXES

Q. What is the issue in this proceeding related to property taxes for the Asbury SCR project?

A. In the Staff's Cost of Service Report, the Staff took a position that the Asbury SCR project should not be included in rates in this proceeding. In response, Empire witness Blake A. Mertens stated the following in opposition to this position:

> Second, if the Asbury SCR is not included in the revenue requirement calculation, not only will Empire not be allowed to earn a return on its investment in a timely manner, it will also not be able to pass on the expenses associated with the SCR to its customers. These expenses include annual property taxes (approximately $220,000 Missouri jurisdiction).

Q. What is the purpose of your testimony on this issue?

A. As explained in the surrebuttal testimony of Staff witness Mark L. Oligschlaeger in this case, the Staff is maintaining its position that the Asbury SCR project be excluded from rate base. However, in the event that the Commission disagrees with the Staff position on this matter, I will explain in this testimony why it should still not allow current rate recovery of the $220,000 of property taxes associated with the Asbury SCR project in any event.

Q. How are property taxes assessed by the taxing authority and paid by the utility?

A. Utilities are required to file with the taxing authorities a valuation of its utility plant/property based on the January 1 assessment date the first of each year. They will later receive property tax bills from the authorities for the amounts assessed, and the utility is required to pay the property taxes by the last day of the same calendar year in which the assessment is made. For example, a utility will pay property taxes at December 31, 200X based upon an assessment made of its asset values as of January 1, 200X.

Q. What assets do taxing authorities value for the purpose of property tax assessments?

A. Among other things, taxing authorities assess the value of the following items for the purpose of property tax payments: 1) plant in service; 2) materials and supplies and 3) construction work in progress (CWIP).

Q. How are property taxes assessed on each of these items treated on Empire's books?

A. Property taxes associated with plant in service and materials & supplies are charged to expense. Property taxes associated with CWIP are capitalized to plant in service and recovered by the utility over the life of the plant assets through depreciation expense once the items go into service.

Q. As of January 1, 2008 (the last appraisal date for Empire's property tax purposes) to what account was its investment in the Asbury SCR project booked?

A. Its entire investment, as of that date, was booked to Account 107, Construction Work in Progress.

Q. How will Empire receive rate recovery of property taxes assessed on its Asbury SCR investment at January 1, 2008?

A. As previously discussed, these property taxes were capitalized by Empire and will be recovered over the useful life of the Asbury SCR equipment from customers through depreciation expense.

Q. Will Empire recognize any expense on its books in 2008 associated with the Asbury SCR project?

A. No, because that entire amount of property taxes associated with the Asbury SCR project was capitalized by Empire.

Q. When is the next time Empire's assets will be assessed for property tax purposes?

A. January 1, 2009. Assuming that the Asbury SCR project will be in-service as of that date, Empire will accrue property tax expense related to the Asbury SCR project and its other plant in service components on its books throughout 2009, until that accrual is trued-up to the actual amount of the property tax bills received by Empire late in that year. Payment of those property taxes will not become due until the last day of 2009.

Q. Regardless of whether the Commission includes the Asbury SCR project in rates in this case or not, should it allow Empire to recover in expense any property tax amounts related to that project?

A. No, because Empire will not incur or book any property tax expense until January 2009.

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's Application for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	)))))	Case No. ER-2008-0093

AFFIDAVIT OF PAULA MAPEKA

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Paula Mapeka, 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 15 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.

P Mapeka
Paula Mapeka

Subscribed and sworn to before me this 24th day of April, 2008.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D Suzie Mankin
Notary Public