

REPORT ON RECOMMENDATIONS CONCERNING MANAGEMENT AUDIT

The Missouri Public Service Commission has ordered Aquila management to respond to the following questions regarding its compensation practices:

- 1) Review present incentive compensation programs to determine if they are serving as a cost effective motivation to employees
- 2) Review and utilize methodologies to fully determine, define and document the total amount of executive compensation
- 3) Re-examine the Company's staffing levels, staff responsibilities and attendant executive compensation levels to ensure such compensation is commensurate with executive responsibilities

Regarding incentive compensation programs, as pointed out in our responses to Data Requests nos. MPSC-0010, and MPSC-0016, Aquila management believes its annual variable compensation plan is an important component the Company's total compensation philosophy which is designed to attract, retain, and motivate employees within budgetary constraints. Each component of Aquila's compensation plans is viewed and reviewed regularly according to those objectives.

The purpose of Aquila's variable compensation plan is to provide competitive incentive opportunities for employees that are consistent with other companies in our industry and to focus employees on important performance objectives. While Aquila's variable compensation plan helps to ensure its total pay position is competitive with market practices of other utilities, it also serves to connect Aquila's total compensation expense with the company's performance on measures important to the customers. So, when the company and the employees are doing well for the customers their variable pay is a little more, and when the company and its employees are not doing well for the customers their variable pay is a little less. Aquila management believes this variability in take home pay does increase employee attention, commitment and discretionary effort toward serving Aquila customers.

The motivational impact of incentive and variable compensation systems have been debated among academicians and practitioners for years. It is commonly held among practitioners that an incentive plan will be motivational if employees generally understand the company's program and have acceptable answers for themselves on the following questions:

- 1. Is the target payout opportunity comparable to what I would earn in other similar jobs?**
- 2. Do I understand the performance metrics, are they important to my job, and can I influence them?**
- 3. Is the process for the award fair?**

The remaining discussion will be aimed at how Aquila's annual variable compensation plan is designed and administered in light of those three questions.

1. Is the target payout opportunity comparable to what I would earn in other similar jobs?

Aquila's philosophy (as previously indicated in our response to Data Request no. MPSC-0016) is to provide market target variable payouts at "expected" performance levels on key organizational goals. Market target incentives are set at the 50%ile (average) of other utilities of similar size. This helps to ensure that Aquila's total pay is fair, competitive and reflective of what employees earn in similar jobs in other utilities. A recent benchmarking survey among 31 electric utility companies by the Electric Utilities-HR Metrics Group (2006 data) showed that 90% of these organizations provided an annual variable compensation, or incentive plan. The median percentage of employees eligible for incentive pay among these 31 organizations was 99%. Given the preponderance of utilities that provide such incentives, Aquila management believes it is important to provide a similar opportunity in order to attract and retain employees. Aquila has been struggling in recent years to keep the target payouts of its variable compensation plan competitive with the market due to performance and budget constraints.

2. Do I understand the performance metrics, are they important to my job, and can I influence them?

Toward that aim, Aquila's variable compensation plan awards individual performance, state performance, and overall company performance. Key performance metrics at the company and state level are heavily represented by measures of customer service, reliability, and safety, of which the majority of Aquila employees are familiar with. At the lowest levels of employees participating in the plan, 80% of their payout opportunity is tied to individual performance on goals and objectives established by their supervisors. Higher level plan participants are appropriately tied more closely to state and company wide performance, as they have a greater responsibility for influencing the company's performance on those broader performance metrics. Aquila employees tend to like the individual component of the plan as it focuses on things most directly under their control.

3. Is the process fair?

This is often the biggest challenge for administrators of incentive plans, and the area where critics often get the most mileage. By design, variable pay varies with performance of the groups, and performance of employees within the group. Therefore, it is not always good news for employees and is sometimes questioned and challenged. Emerging research by the Corporate Leadership Council suggests that a

key influence in an employee's perception of fairness of a variable compensation plan is tied to frequent interactions with his or her supervisor on the following themes:

- How they are doing against expectations
- How that performance will translate into rewards and recognition, and
- Clear communications regarding the company's performance against the plan metrics.

Aquila communicates performance levels on key dashboard measures used in the incentive plan monthly, and supervisors are encouraged to meet with employees regarding their performance regularly.

In summary, there is no perfect management approach for motivating and retaining employees. Each management philosophy and practice has its relative strengths and weaknesses and must be managed accordingly. Aquila firmly believes its annual variable compensation plan helps in attracting, retaining and motivating employees in the service of Aquila customers and strives to improve the administration of the plan annually. Providing variable compensation opportunities helps keep Aquila competitive in the labor market for talent by recognizing that employees in other utilities, doing the same jobs, are almost always eligible for variable compensation opportunities. It also helps to motivate employees by ensuring a link between the employees take home pay and their contribution to Aquila's performance on important customer measures. Additionally, Aquila's approach to variable compensation administration supports customer interests by ensuring that there is a meaningful link between Aquila's performance on key customer metrics and its overall compensation expense.

Regarding executive staffing levels and executive compensation, Aquila leadership and staff is currently immersed and fully engaged in transition planning related to the proposed merger with Great Plains Energy and the asset sale to Black Hills. Given the scope and scale of the transaction related activities, it would not be prudent to review or change Aquila's staffing at this time. Aquila leadership has held initial discussions of possible staffing adjustments at the executive level should the merger efforts fail. The process for determining executive compensation and the logic for the current levels are disclosed in detail in our response to Data Request no. MPSC-0016.