Exhibit No.:	
Issues:	*Incentive Compensation*
Witness:	*Amanda C. McMellen*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case No.:	*ER-2006-0315*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

AMDANDA C. MCMELLEN

THE EMPIRE DISTRICT ELELCTRIC COMPANY

CASE NO. ER-2006-0315

Jefferson City, Missouri
August 2006

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

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of The Empire District Electric Company of Joplin, Missouri for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the Company.	)))))	Case No. ER-2006-0315

AFFIDAVIT OF AMANDA C. MCMELLEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Amanda C. McMellen, 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 12 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.

Amanda C McMellen

Amanda C. McMellen

Subscribed and sworn to before me this 17th day of August, 2006.

Toni M Charlton

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

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THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Q. Please state your name and business address.

A. Amanda C. McMellen, 200 Madison Street, Suite 440, Jefferson City, MO 65102.

Q. Are you the same Amanda C. McMellen that has previously filed rebuttal testimony in this case?

A. Yes, I am.

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 certain corrections to the Staff's case and the Company's incentive compensation plans.

EXEUTIVE SUMMARY

Q. Please provide a brief summary of your testimony.

A. My testimony addresses the Staff's position regarding incentive compensation plans at Empire. The Staff has consistently followed the same methodology and criteria established by the Commission almost twenty years ago. The Staff does not object to Empire's practice of offering its employees variable compensation based on attainment of certain goals. However, incentive compensation for all employees should be based on goals that benefit the ratepayer.

STAFF CORRECTIONS

Q. What correction has the Staff made regarding the Operations and Maintenance (O&M) expense factor reflected in its direct filing?

A. The Staff found an error in its calculation of the O&M factor. This error has been corrected and the O&M expense factor has been updated from 72.56% (Staff direct) to 75.00%.

Q. Does the Company agree with this correction?

A. Yes. Empire witness Jayna R. Long agrees with this correction on page 6, lines 13-16, of her rebuttal testimony.

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

A. Yes. Empire witness Long mentions on page 11 of her rebuttal testimony that the Staff made a duplicate adjustment regarding stock options.

Q. Does the Staff agree with this correction?

A. Yes. Adjustment S-79.4 was a duplicate adjustment and has been eliminated from the Staff's case.

INCENTIVE COMPENSATION

Q. Please explain the Company's position on this issue as indicated in the rebuttal testimony of Empire witness Bauer.

A. Empire witness Gene E. Bauer, PhD., implies that the Company's incentive compensation program is simply the "at risk" portion of its overall executive compensation. Dr. Bauer advocates that the Commission should not evaluate Empire's "at risk" incentive compensation separately from its base salary compensation in setting rates. Dr. Bauer believes that the Company should be able to recover all costs associated with incentive compensation in order to maintain a total compensation package that is comparable to similar executives at comparable employers. Dr. Bauer applies this same philosophy to the incentive compensation awarded to non-executive employees as well.

Q. Please explain the Staff's position on this issue.

A. The Staff has proposed adjustments to the Company's executive and non-executive incentive compensation expense, including the disallowance of a portion of the specific payments for achieving goals, referred to as annual cash incentives, and all costs associated with stock options. The Staff also has not included costs for performance shares awarded to Empire executives.

Q. Does Dr. Bauer identify Empire's compensation "philosophy"?

A. Yes. A summary of Empire's executive compensation "philosophy" is provided on page 6, lines 14-20, of Dr. Bauer's rebuttal testimony.

Q. Does the Staff agree with Dr. Bauer's comments?

A. The Staff believes that additional details related to Empire's executive compensation targets are important in order to understand the compensation targets presented in Dr. Bauer's testimony. The Staff received a copy of the Highly Confidential *Empire District Electric Company Executive Compensation Review*, Discussion Draft, October 2003, Revised January 2004, (Compensation Review) in response to Staff Data Request No. 244 in this proceeding. This document is still used by Empire today to support its compensation policies. I have attached this document as Highly Confidential Schedule 1 to my surrebuttal testimony. The targeted percentiles selected for the three components of executive compensation, base salary, total cash compensation (base salary plus annual incentive) and total direct compensation (total cash compensation plus long-term incentives) are based on the

HayGroup's Executive Compensation Report of 700 (All-Exec Group) organizations across all industry sectors, not the Peer Group Compensation Market (peer group) of twelve publicly traded electrical utilities, referred to by Dr. Bauer in his rebuttal testimony on page 15, lines 21-23, continuing onto page 16, lines 1-11. Explanations of Empire's philosophy and a further description of executive groups that the targeted percentiles are based upon are found on pages 3-4 of the Compensation Review.

Q. Does Dr. Bauer appear to agree with the Commission's prior decisions concerning the inclusion or exclusion of incentive compensation?

A. No. Dr. Bauer does not appear to advocate that the Commission or its Staff perform any review of the targets/goals employed in a utility's incentive compensation program. He believes that the incentive compensation awarded to the employees at Empire should be fully recovered in rates because the total compensation is reasonable compared to other companies. This approach is inconsistent with the Commission's prior decisions on incentive compensation issues.

Q. What is the Staff's incentive compensation position based upon?

A. The Staff's incentive compensation position in this proceeding is based upon the Commission's decisions in prior cases beginning with the Report and Order in Case Nos. EC-87-114 and EC-87-115, Union Electric Company, which states:

> At a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan.

Q. How has the Staff interpreted this and other Commission decisions on incentive compensation in this case?

A. The Staff's interpretation of the Commission's criterion for improvement of existing performance anticipates that employees perform at a level beyond their basic job requirements in order to receive incentive compensation. Goals should be set to quantify specific job performance, using objective criteria that can be directly identified with the incentive compensation program. The goals should also focus on employee performance that can be associated with ratepayer benefits. The Commission has been applying these criteria to the issue of incentive compensation for almost twenty years. Most recently, the Commission in its Report and Order for Case No. GR-2004-0209, Missouri Gas Energy, re-affirmed its position:

> 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.

Q. Respecting page 11 lines 3-22 of Dr. Bauer's rebuttal testimony, is the Staff's disallowance of a portion of the annual cash incentives reasonable?

A. Yes, I relied on the following historical Commission standard regarding incentive compensation: at a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the plan. The Staff believes this is a reasonable standard and the Staff's adjustment is a reflection of this standard by allowing annual cash incentives for results that were at or under budget where the incentive compensation was tied to a performance goal respecting the budget. Allowing payments for budget related goals that reward results that are over budget, as Empire has done, would be rewarding actions that do not improve existing performance.

Q. Has the Staff, in fact, been conservative in its treatment of the cash incentives?

A. Yes. By disallowing payments for results that were over budget, the Staff has correctly utilized the historical Commission standard. This is a conservative approach particularly appropriate in the Empire case due to the fact that the Staff has generic concerns regarding the use of budgets as performance indicators and considered disallowance of all incentive compensation tied to budget goals. The executives of Empire receiving the incentives are the same individuals who approve the budgets that are used as performance indicators for the cash incentives. Under Empire's approach to incentive compensation, there is an incentive for executives to set budgets at a level that can be achieved rather than at a level that represents true improvement in performance.

Q. Respecting pages 12 and 13 of Dr. Bauer's rebuttal testimony, please explain why the Staff has disallowed the cost of stock options included in the executive long-term incentive.

A. The Staff has disallowed the cost of stock options for several reasons. The granting of these options is not associated with any increase in duties or achievement of goals and no measurement of whether any specific level of performance was met or exceeded. In addition, the triggering mechanism for these stock options is share price appreciation. There are too many variables beyond the control of the individuals receiving the incentive compensation for this financial goal to be appropriate and there is the separate matter of the appropriateness of the goal of share price appreciation. Changes in share price can result from changes in operating results, which in turn are affected by such items as changes in weather and changes in fuel prices. The executives of Empire do not have any control over the weather, matters that cause disruptions in the flow of oil and gas from the producing countries, all of which can affect fuel cost and overall operating results.

Q. Respecting pages 13 and 14 of Dr. Bauer's rebuttal testimony, why has the Staff not included in its case the cost associated with performance share awards?

A. The triggering mechanism for the awarding of the performance shares is total shareholder return (TSR), which is defined as Empire's stock price plus dividends paid out. The total shareholder return of Empire is compared to that of a peer group chosen by the HayGroup. Since the triggering mechanism is total shareholder return, obviously tied to shareholder benefits, the Staff believes that the cost of this benefit should be borne by the shareholder. By using the performance of a peer group to determine an incentive award, the Company has established criteria that are based on financial performance and factors beyond Empire's control. There is no direct correlation between Empire's stock price levels and amount of dividend payouts and benefits to Empire ratepayers.

Q. Do you agree with Dr. Bauer when he states that the Commission and the Staff should show substantial deference to the Compensation Committee's determination of the appropriate measures and goals at page 12 of his rebuttal testimony?

A. No. Empire has the right to set employee base salary levels and develop incentive compensation plans as it chooses. The determination of costs included in the utility rates of Empire's Missouri ratepayers is the responsibility of the Commission. The Staff has been given a role in the ratemaking process, pursuant to statute and Commission rule, to make recommendations concerning, among other things, the recovery of utility expenses and the setting of utility rate levels.

Q. Do you agree with Dr. Bauer's interpretation of your direct testimony, discussed at page 12, line 23, to page 13, lines 1-2, of his rebuttal testimony that you have assumed that executive compensation in the form of stock options and dividend equivalents, at executive compensation provide no benefit to Empire?

A. No, I do not. The Staff is not contending that a corresponding benefit to Empire shareholders associated with the executive long-term incentive stock options and dividend equivalents does not result from offering these types of incentive compensation. However, Dr. Bauer provides no support that these executive long-term incentives benefit ratepayers.

Q. Please explain.

A. There are no goals associated with the executive long-term incentives except for the TSR goal. The TSR measures Empire's stock price and dividends paid compared to the peer group. Again, there is no direct correlation between the level of Empire's stock price and dividend payouts and benefits to Empire ratepayers.

Q. Does Empire rely on the peer group to determine its targets for base salary, total cash compensation or total direct compensation?

A. No. Please refer to Highly Confidential Schedule 1-4 through Schedule 1-5 for an explanation of the philosophy and methodology used to determine Empire's targets for compensation.

Q. What is the relevance of Dr. Bauer's rebuttal testimony, respecting the value of peer groups at pages 14-16?

A. None. The peer group was only used by the HayGroup and Empire as a trigger for the awarding of long-term incentive performance shares based upon the TSR goal. While the Compensation Review includes data related to the peer group as a gauge to compare to the All-Exec Group, Empire's compensation targets by category (base salary, total cash compensation and total direct compensation) are based upon the All-Exec Group of 700 organizations.

Q. Does the Staff agree with Dr. Bauer's representation of the peer group?

A. Dr. Bauer's general representation of peer groups appears on the surface to be reasonable, yet the details in Highly Confidential Schedule 1 specific to Empire's selected peer group do not support his overall conclusions concerning Empire's incentive compensation program in his testimony. Please refer to Schedule 1-20, Appendix B, attached to my surrebuttal testimony where comparative financial information of the peer group utilities is provided. On page 15, lines 10-11, Dr. Bauer states, "Commonality of industry and size generally are the most important traits for an executive compensation peer group." The Staff would agree that these traits are important but the peer group selected for the HayGroup analysis and approved by Empire's Compensation Committee does not appear to be the best fit for comparisons to Empire.

Several of the peer group utility companies are considerably larger than Empire. If size is relative to total assets, the largest peer group company has over $3 billion in total assets compared to Empire's $970 million. If size is relative to total revenues, the largest peer group company has over $1.1 billion in total revenues compared to Empire's $306 million. It is not surprising that the peer group utility company with the largest chief executive officer total direct compensation ($1.9 million) also has assets and total revenues well in excess of

Empire's. The Staff would also emphasize that the peer group analysis does not appear to support either annual incentives or long-term incentives for all executives. Appendix A of Highly Confidential Schedule 1-15 through Schedule 1-19 shows that for the selected comparable executive positions, there are utility companies within the peer group that do not have annual incentives and/or long-term incentives.

The Staff's review of peer group utility company public information also indicates that the mix of regulated to non-regulated business activity, the region of the country in which the utility company operates and the different corporate structures of the utility companies make comparisons to Empire less appropriate. Comparisons to utility companies within the Midwest region or just Missouri within a peer group analysis would be more valid. Also, the Staff believes that cost of living adjustments should be made when comparing compensation levels at Empire to other companies in the peer group.

Q. Has the Staff performed an analysis of Empire's executive compensation or management incentive plan (MIP) in prior cases?

A. Yes. The Staff documented the base salaries and MIP expenses in Empire Case Nos. ER-97-81, ER-2001-299, ER-2002-424 and ER-2004-0570 and has consistently applied the Commission's decisions previously noted.

Q. Has the disallowance of MIP expenses been a contested issue in any of these cases before the Commission?

A. No. While other aspects of Empire’s incentive compensation program were contested by the Staff and Empire in Case No. ER-2001-299, the Staff’s MIP disallowance was not contested by Empire in that proceeding.

Q. Is the Staff opposed to the recovery of "at risk" executive incentive compensation as stated by Dr. Bauer on page 9, line 11, continuing onto page 10, lines 1-10, of his rebuttal testimony?

A. No. The Staff is not opposed to a portion of executive compensation being placed "at risk." If Empire shows that this approach results in ratepayer benefits, the Staff would not oppose recovery of these costs in cost of service.

Q. Does the Staff apply these same principles to salaried non-officer (non-executive) employees?

A. Yes. Although Empire has a well structured and documented incentive compensation program for non-executive employees, not all of the goals provide benefits to the ratepayers. Incentive compensation costs associated with the goals regarding items such as normal job duties (as stated by the Company in response to Staff Data Request No. 240) or non-regulated activities, which do not provide benefits to ratepayers, and should not be recovered in cost of service.

Q. Is the Staff aware of any executive retention problem at Empire?

A. No. The executives that are currently at Empire have held other positions with the Company before working their way up into their current executive positions. Dr. Bauer did not address any recruitment or retention problems in his rebuttal testimony.

Q. Does Dr. Bauer directly address the Staff's disallowance of the "lightning bolt" incentives included in your direct testimony?

A. No. Dr. Bauer does not specifically address Empire's position regarding the "lightning bolt" awards.

Q. Is the incentive compensation disallowed by the Staff a large percentage of payroll costs?

A. No. The amounts disallowed by the Staff for incentive compensation is only a small portion of payroll costs as shown on Highly Confidential Schedule 2 attached to my surrebuttal testimony.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

Schedules ACM 1 and 2 have been Deemed Highly Confidential in their Entirety.