Exhibit No.:	
Issues:	*Iatan Disallowances,* *Prepayments (Iatan and Plum Point);* *Property Taxes;* *Incentive Compensation*
Witness:	*Amanda C. McMellen*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*ER-2012-0345*
Date Testimony Prepared:	*February 4, 2013*

MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

UTILITY SERVICES - AUDITING

SURREBUTTAL TESTIMONY

OF

AMANDA C. McMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2012-0345

Jefferson City, Missouri
February 2013

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

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AMANDA C. McMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2012-0345

Q. Please state your name and business address.

A. Amanda C. McMellen, 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 Amanda C. McMellen who has previously contributed to the Staff's Cost of Service Report dated November 30, 2012 in Case No. ER-2012-0345 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 Blake A. Mertens, regarding Iatan disallowances and prepayments (Iatan and Plum Point); L. Jay Williams, regarding the Company's property tax expense; and Kelly S. Walters, regarding the Company's incentive compensation expense.

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 Iatan disallowances. Although Mr. Mertens discusses the cost reviews Empire conducted associated with Iatan projects, Staff's position is that Empire should still record their allocated portions of the Iatan disallowances that were ordered by the Commission in its Report and Order in File No. ER-2010-0355 because ratepayers should not be responsible for costs that have been found to have been imprudently incurred.

Next, I will explain Staff's position on the disallowance of certain accounts Empire has categorized as prepayments. Staff's position is that it is inappropriate to include these accounts in rate base, at this time.

I will also address in this testimony Staff corrections regarding property tax expense and the effects of these changes in Staff's direct case.

Last, I address Staff's position regarding incentive compensation expense at 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 attainment of certain goals. However, Staff recommends incentive compensation for all employees should be based on goals that provide a direct benefit to ratepayers, not goals that primarily or entirely benefit shareholders.

<u>IATAN DISALLOWANCES</u>

Q. Have you reviewed the rebuttal testimony of Empire witness Mertens regarding Iatan disallowances?

A. Yes, I have.

Q. Do you agree with Mr. Mertens that due to Empire's controls regarding costs associated with Iatan I, Iatan 2 and Iatan Common property that Empire expenditures found imprudent by this Commission should be included in Empire's rate base?

A. No, I do not. Staff's recommendation is for Empire to make proportional adjustments for all Iatan disallowances, as stated in the Commission's Report and Order in File No. ER-2010-0355, Kansas City Power & Light Company ("KCPL Iatan Order").

Q. What specific adjustments did Staff recommend in the Empire case?

A. In the KCPL Iatan Order, the Commission ruled that the "costs for construction resurfacing, campus relocation for the Iatan 2 Turbine Building, the WSI change order, and the temporary auxiliary boiler shall be excluded from rate base." The dollar amounts of these adjustments are shown below:

Highly Confidential in its entirety.

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Q. Is Empire bound by any terms or conditions in previous stipulations and agreements related to the Iatan 1 and Iatan 2 projects?

A. Yes. Among other things, Empire is bound by the terms and conditions of its "Regulatory Plan" per the "Stipulation and Agreement" in File No. EO-2005-0263, approved by the Commission effective August 12, 2005, which states on page 5 as follows:

> If any party proposes the disallowance of Iatan 1 or Iatan 2 costs, Empire agrees not to seek to avoid such disallowance on the ground that such expenditures were the responsibility of KCPL and were not within Empire's control.

Q. Did Staff ignore the fact that Empire is in an ownership agreement with KCPL, as alleged by Mr. Mertens at page 3, lines 11 to 22?

A. No.

Q. Does Mr. Mertens address the propriety of including amounts the Commission found to be imprudently incurred, and therefore not of benefit to ratepayers, in Empire's rate base?

A. No, he does not.

<u>PREPAYMENTS</u>

Q. Have you reviewed the rebuttal testimony of Empire witness Mertens regarding Iatan and Plum Point prepayments?

A. Yes, I have.

Q. Do you agree with Mr. Mertens that these accounts should be included in Empires' revenue requirements as prepayments?

A. Not at this time. Staff is still researching this issue in regards to any interest that may be accrued, credited or actually paid to Empire for these accounts. If interest is being accrued, credited or actually paid to the Company, inclusion in rate base is inappropriate.

PROPERTY TAX EXPENSE

Q. Have you reviewed the rebuttal testimony of Empire witness Williams regarding property tax expense?

A. Yes, I have.

Q. Do you agree with Mr. Williams that Staff has made errors regarding property tax expense?

A. Yes. Staff agrees with the corrections Mr. Williams references on page 2 and page 3 (lines 1 to 12), of his rebuttal testimony.

Q. What is the impact of these corrections?

A. The corrected Staff adjustment to property tax expense will increase by approximately $480,000.

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 and the long-term incentives. Staff did not adjust Empire executive's base salaries in its' direct case.

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

A. On page 3, lines 21 to 23, and page 4, lines 1 to 8 of Ms. Walters' rebuttal testimony, she states:

> As communicated by Hay Group, companies similar to Empire typically utilize the same approach as Empire by incorporating a mix of base salary, short-term, 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 is a key factor in ensuring the alignment of an executive's performance with the interests of customers and shareholders. The approach is utilized by all but one of the peer-group companies as well as all investor owned electric utilities operating in Missouri.[1]

Q. How does Staff respond to the above mentioned portion of Ms. Walters' rebuttal testimony?

A. Staff agrees with Ms. Walters' statement that all investor-owned electric utility companies in Missouri include a mix of base salary, short-term and long-term incentives built into their total executive compensation package. Staff would also note many large gas and water utilities in Missouri include similar mixes in their total executive compensation packages. However, at many Missouri regulated utilities, Staff has 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.

[1] Emphasis in original.

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 her rebuttal testimony on page 5, Ms. Walters 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 the peer group. Please respond.

A. Ms. Walters 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 believes 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 that 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. Ms. Walters 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 how Staff's calculation of MIP is different in this case.

A. Typically Staff's policy is to not include incentive amounts in rates that have no set performance goals attached to them. Due to the Joplin tornado in 2011, no MIP awards were awarded for set performance goals in early 2012. Instead, senior officers received "discretionary" incentive awards in early 2012. Staff realizes the events that took place in 2011 were "abnormal" and that some amount of MIP awards have been included in past cases going back to 2004. So, in this case Staff calculated an average MIP expense based on the MIP amounts Staff allowed in previous cases, including a zero MIP award applicable to 2011. The amounts Staff allowed in previous cases were based on assessment of actual set performance goals. Therefore, Staff's recommendation takes into consideration the criteria used in past cases while recognizing the effect of the 2011 tornado.

Q. On page 6 of her testimony, Ms. Walters' references specific adjustments that Staff made to disallow a portion of the executive incentive compensation and makes the statement that these adjustments are unreasonable. Please comment.

A. Ms. Walters makes the statement that Staff's adjustments are unreasonable because no awards are payable to an executive officer unless they perform above the minimum or threshold level of performance. What Ms. Walters doesn't take into account is what each specific goal pertains to. Ms Walters 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 line of reasoning and believes that each individual goal should be scrutinized to determine if it has a direct benefit to ratepayers, or if it is a part of the normal job duties of an executive and does not go above and beyond the demands of their normal daily work. Although Staff did not look at specific goals in this case due to the "abnormal" conditions in 2011, it is still Staff's policy to disallow only those awards given to executives that did not have a direct benefit to ratepayers or that appeared to be part of normal job duties such as goals related to meeting attendance, record management and financing of capital expenditures.

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, because these goals are associated with the provision of safe, adequate and reliable service to the ratepayers.

Q. Please explain 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 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 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 the appropriate rate treatment of incentive plans?

A. Yes. In the Commission's Report and Order issued in Case No. GR-96-285, 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 requirement.

The Commission further 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 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.

Non-Executive Salaried Compensation

Q. In regards to the non-executive salaried employee incentive compensation issue, is it true as referenced in Ms. Walters' rebuttal testimony at page 10, lines 14 to 20, Staff allowed the amount of non-executive salaried employees that were compensated in the test year, that is not related to "Lightning Bolt" awards?

A. Yes, this is correct. Although there was a reduction to department heads' salaries due to the financial condition caused by the tornado, Staff's position is to include employees at the most current salary that is known and measurable. Payroll will be updated in the true-up in this case. If any of these employees' salaries have increased through December 31, 2012, it will be included in the payroll adjustment in the true-up.

Lightning Bolts

Q. Did Staff disallow Empire's "Lightning Bolt" awards?

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

Q. Ms. Walters states the Lightning Bolt 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 that employees can "work toward," and they are paid out at the senior management's discretion.

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.

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 Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	)))))	Case No. ER-2012-0345

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 4th day of February, 2013.

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