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COMMISSION STAFF DIVISION

AUDITING DEPARTMENT

SURREBUTTAL TESTIMONY

OF

JERMAINE GREEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2016-0023

*Jefferson City, Missouri
May 2016*

Staff Exhibit No. 9
Date 6-02-16 Reporter RF
File No. ER-2016-0023

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SURREBUTTAL TESTIMONY

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JERMAINE GREEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

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1 A. In this testimony, I will first address the issue of O&M expenses and Empire's
2 proposed adjustment in determining its normalized O&M expenses for its Riverton Power Plant.
3 It is Staff's position that the normalized expense for this combined cycle unit be adjusted using
4 historical O&M cost figures from another Empire generating unit, the State Line Combined
5 Cycle ("SLCC") unit.

6 Next, I will explain Staff's recommendation regarding the Company's proposed Riverton
7 Unit 12 O&M tracker "base level." Staff is proposing a different expense level be used as the
8 base amount for this tracker than that advocated by Empire.

9 Lastly, I will address Staff's position regarding incentive compensation expenses
10 for Empire. The incentive compensation adjustments proposed by Staff apply to three
11 different forms of compensation offered by Empire: (1) the Management Incentive
12 Compensation Plan ("MIP") for short-term executive incentive compensation; (2) long-term
13 equity incentive compensation to executives, and (3) "Lightning Bolts" for short-term
14 discretionary incentive compensation to non-management employees. Staff does not object to
15 Empire's practice of offering its employees variable compensation based on the attainment of
16 certain goals. However, Staff recommends that, for this expense to be allowed in rates, incentive
17 compensation for all employees should be based on goals that provide a direct benefit to
18 ratepayers, not goals which have a primary purpose of benefiting shareholders.

19 **RIVERTON OPERATIONS AND MAINTENANCE EXPENSE**

20 Q. Have there been any modifications to Staff's position since its direct filing as it
21 relates to Riverton Unit 12 normalized O&M Expense in this case?

22 A. Yes. After discussions with the Company, Staff has modified its filed position in
23 direct testimony in which a five-year historical average of prior Riverton Station O&M expenses

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1 were used to determine the normalized maintenance costs for the Riverton generating facility.
2 Instead, Staff will adopt the Company's proposed adjustment based on projections for a
3 combined cycle unit operation using the SLCC historical O&M costs. The dollar amount of this
4 adjustment will not be determined until after Staff reviews additional work papers that the
5 Company has committed to providing.

6 Q. Why does Staff typically analyze five years of data for O&M expense for
7 purposes of normalization, and what is the justification for changing this methodology in regard
8 to Riverton Unit 12?

9 A. Staff normally uses an averaging technique to set rates for generation O&M
10 normalization purposes for many years in many different rate cases, and will likely continue to
11 do so in the future. Staff still believes a multi-year average, such as a five-year average, is a
12 reasonable approach because it uses actual expense incurred and eliminates the impact of annual
13 fluctuations in these expenses. However, Staff believes in this case an exception to the five-year
14 historical average should be made as it relates to the Riverton generating facility, due to the
15 many operational changes that have occurred at the Riverton station in the last five years. First,
16 Riverton Unit 12 has been converted from a simple cycle unit to a combined cycle unit that
17 became operational May 1, 2016. Also, Riverton Units 7 and 8 were recently retired. Therefore,
18 it is expected that all of these changes will cause the ongoing level of O&M costs for Riverton to
19 significantly change. For this reason, including the historical five-year normalized average O&M
20 costs for the Riverton Units would not be appropriate in these circumstances.

21 Q. How does this change impact the ongoing level of Riverton O&M expenses?

22 A. The ongoing level of O&M expense for Riverton is expected to increase by
23 \$823,269 from the level in Staff's direct filing. As stated earlier, Staff will update the adjustment

1 to its direct filing once the additional information used by the Company in determining this
2 proposed ongoing normalized expense is provided to Staff.

3 **RIVERTON UNIT 12 O&M TRACKER BASE COST**

4 Q. What is Staff's recommendation concerning the Company's proposed Riverton
5 Unit 12 O&M tracker base?

6 A. It is Staff's position that the tracker base level should remain at \$2.7 million for
7 costs associated with the Long-Term Maintenance Contract with Siemens Instrumentation,
8 Controls and Electrical Group ("Siemens Contract") instead of the \$3.9 million as proposed by
9 the Company, until there is sufficient operational history to determine if a rebase is appropriate.
10 Furthermore, after discussions with the Company, it is also now Staff's position to expand the
11 accounts included in the tracker to account for the additional O&M costs associated with
12 Riverton Unit 12 that fall outside of the Siemens Contract. As discussed above this amount is
13 approximately \$823,269.

14 Q. Please explain Staff's methodology in determining the amount for the
15 tracker base.

16 A. The costs payable under the Siemens Contract are based in part on the amount of
17 equivalent operating hours ("EOH") incurred by the Riverton 12 unit. Staff's methodology for
18 determining the Riverton Unit 12 tracker base of \$2.7 million was based on EOH estimates
19 provided by the Company in Rate Case No. ER-2014-0351, with the exception of 2,475 EOH's
20 that the Company proposed for the commissioning of the new Riverton 12 unit as a combined
21 cycle generation unit. It was Staff's position in that case that the 2,475 hours represent a
22 one-time cost and should not be included in ongoing expense levels or in a tracker mechanism.
23 The base amount of \$2.7 million Missouri Jurisdictional for the Riverton Unit 12 tracker was

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1 | agreed to in Empire's last general rate case, No. ER-2014-0351, as part of the *Non-Unanimous*
2 | *Stipulation and Agreement*.

3 | Q. Do you agree with Empire's methodology in calculating its Riverton Unit 12
4 | tracker base in this proceeding?

5 | A. No. Staff believes the estimated EOHs agreed to in Rate Case No. ER-2014-0351
6 | to determine the base is appropriate, instead of the current base proposed by the Company.
7 | Furthermore, in his rebuttal testimony on page 4, lines 11 and 12, Mr. Woods states "Empire
8 | freely admits that its projected expenses for the unit are educated estimates, and may be wrong –
9 | such is the reality for any forecast." Therefore, until Riverton Unit 12 has sufficient historical
10 | O&M expense data for analysis, a rebase to \$3.9 million Missouri Jurisdictional is not
11 | appropriate at this time.

12 | Q. Will Empire be harmed if Staff's recommended tracker base of \$2.7 million is
13 | used to set rates instead of the Company's recommendation of \$3.9 million?

14 | A. No. A tracker is a two-way regulatory mechanism that provides for the recording
15 | of a regulatory liability when the Company spends less than the targeted base amount and the
16 | recording of a regulatory asset when the opposite occurs. This mechanism has potential benefits
17 | for both the Company and its ratepayers. A tracker helps to ensure that neither the Company nor
18 | its customers will experience a windfall as a result of changes in the O&M level of expenses.
19 | As a result, the tracker base of \$2.7 million will not adversely impact the long-term ability of the
20 | Company to recover the new level of O&M expenses associated with operation of Riverton
21 | Unit 12 as a combined cycle unit.

1 INCENTIVE COMPENSATION

2 Management Incentive Plan

3 Q. Please explain the executive compensation program at Empire.

4 A. The executive compensation program at Empire, known as the Management
5 Incentive Compensation Plan ("MIP"), is comprised of three basic elements: (1) base salary;
6 (2) annual (short-term) cash incentives based on threshold (minimum expected) target and
7 maximum performance measures; and (3) long-term incentive plans ("LTIP").

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

10 A. The disagreements concern the annual (short-term) cash incentives for Empire
11 executives and department heads as well as the long-term incentives. Staff did not adjust the
12 Empire executives' base salaries in its direct case.

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

14 A. On page 3, lines 12 to 17, of Mr. Beecher's rebuttal testimony, he states:

15 Empire's approach is comparable, by incorporating a mix
16 of base salary, short-term incentives, and long-term
17 incentives into a total executive compensation package.
18 This reflects a "best practices" approach used by companies
19 both inside and outside the utility industry. Rather than
20 relying solely on fixed compensation in the form of base
21 salary, this best practices approach also includes a
22 considerable measure of variable (at risk) compensation in
23 the total compensation package. This approach aligns
24 employee performance with the interests of customers and
25 shareholders.¹

26 Q. How does Staff respond to the above mentioned portion of Mr. Beecher's
27 rebuttal testimony?

¹ Emphasis in original.

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1 A. Staff agrees with Mr. Beecher's statement that companies in the utility industry
2 typically include a mix of base salary, short-term and long-term incentives into their total
3 executive compensation package. However, as it regards to Missouri regulated utilities, Staff has
4 consistently recommended the disallowance of incentive compensation components that are
5 primarily intended to maximize shareholder wealth or do not provide a direct benefit to
6 ratepayers. The position Staff is taking in this matter is no different than what it has
7 recommended in past rate cases for Empire and other Missouri utilities.

8 Q. Is Staff opposed to the recovery of "at risk" executive incentive compensation?

9 A. No. Staff is not opposed to a portion of executive compensation being placed
10 "at risk." If Empire shows that this approach is based upon goals and objectives that result in a
11 ratepayer benefit, Staff would not oppose recovery of these costs in the cost of service.

12 Q. In his rebuttal testimony on pages 3 through 4, Mr. Beecher attempts to justify
13 rate recovery for Empire's executive incentive compensation expenses on the grounds that
14 Empire's total compensation package for its executives is lower than that of the peer group.
15 Please respond.

16 A. Mr. Beecher appears to be arguing that the Commission should place a different
17 and more lenient ratemaking standard for incentive compensation on utilities that are perceived
18 to pay less in compensation expenses than the industry or area norm. However, Staff proposes
19 that this argument misses the real point of this issue. Staff is not proposing its adjustments to
20 Empire's incentive compensation expense on the grounds that Empire's incentive compensation
21 is excessive or that it would cause Empire's total compensation package for executives to be
22 excessive. Rather, Staff's adjustments are based upon the belief that it is inappropriate to charge
23 customers for costs primarily associated with shareholder benefit or which do not result in real

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1 improvement in utility performance. Whether a utility pays high or low total compensation
2 levels should not affect this fundamental concern.

3 Q. Mr. Beecher seems to imply that a company's compensation package should be
4 judged in total, based upon the amount of total compensation, with no separate or distinctive
5 criteria applied to variable incentive-type compensation. Do you agree?

6 A. No. Base salaries and incentive compensation are distinct types of employee
7 compensation, and the Commission has historically applied specific criteria before allowing
8 incentive compensation expense to be included in rates. The Commission's criteria have been
9 based upon whether attainment of a Company's goals/targets would provide a benefit to its
10 customers, and whether the goals/targets are designed to actually improve employee and
11 company performance.

12 Q. Please explain Staff's calculation of allowable MIP in this case.

13 A. In order to determine the appropriate amount to include for the MIP in this case,
14 Staff performed a review of all the incentive metrics used to measure each individual goal and
15 disallowed all the actual payouts to Empire executives and department heads associated with
16 performance measures tied to meeting financial goals; i.e. "earnings per share" targets. It is
17 Staff's position that any incentive goals associated with enhancing the value of a utility's
18 stock price and the achievement of these goals is a benefit to Empire's shareholders, and not
19 Empire's ratepayers.

20 Q. On page 4 of his testimony, Mr. Beecher references specific adjustments that Staff
21 made to disallow a portion of the executive incentive compensation and made the statement that
22 these adjustments are unreasonable. Please comment.

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1 A. Mr. Beecher makes the statement that Staff's adjustments are unreasonable
2 because Empire's total target compensation is set at the 25th percentile of a comparable industry
3 peer group and the awards are only payable to an executive officer if they perform above the
4 "minimum" or "threshold" levels of performance. Mr. Beecher doesn't take into account what
5 each specific goal pertains to. Mr. Beecher appears to take a position that Staff should not be
6 looking at each individual goal for reasonableness because they are all a part of the total
7 compensation package, and it should not matter what each specific goal is. Staff disagrees with
8 this reasoning and believes that each individual goal should be scrutinized to determine if it has a
9 direct benefit to ratepayers. Staff reviewed all of the specific goals for Empire's executives in
10 this case and it is Staff's position to disallow only those awards given to executives and
11 department heads that do not have a direct benefit to ratepayers.

12 As had been customary in past rate cases, Staff's policy is still to allow incentives related
13 to customer service, reliability and safety, and environmental compliance. These goals are
14 associated with the provision of safe, adequate and reliable service to the ratepayers.

15 Q. Mr. Beecher is in his rebuttal testimony alludes to Empire's Total Compensation
16 being in the 25th percentile and is, therefore, more conservative as compared to the peer group.
17 How does Staff respond?

18 A. Staff's review of the similar sized utilities that are used in the peer group study
19 reveal that 55% of the companies were based in western and eastern states of the United States;
20 areas that are understood to command higher levels of compensation due to the higher cost of
21 living. Therefore, it stands to reason that any comparison of Empire's total compensation would
22 inherently show lower results when compared to compensation levels of utility companies
23 operating in larger metropolitan cities in other areas of the country. In short, Empire's rank of

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1 | the 25th percentile is not necessarily a fair comparison when considering economic conditions in
2 | Joplin, Missouri to larger cities. As stated earlier, Staff is not proposing its adjustments to
3 | Empire's incentive compensation expense on the grounds that Empire's incentive compensation
4 | is excessive, rather, Staff's adjustments are based upon the belief that it is inappropriate to
5 | charge customers for costs primarily associated with shareholder benefit or which do not result in
6 | any real benefit to the ratepayers.

7 | Q. Please describe Empire's long-term incentive plan ("LTIP").

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

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

11 | A. Staff proposes to disallow LTIP awards for the following reasons: (1) the awards
12 | are based on measures that primarily benefit shareholders, such as shareholder return
13 | (maximizing the dividends paid to shareholders) and stock price goals (the value of the
14 | stock increasing over time); (2) the granting of these stock options is not associated with any
15 | increase in duties or achievement of goals and is not tied to any specific level of employee
16 | performance; and (3) the stock options and performance-based restricted stock are equity-based
17 | compensation that do not result in cash outlays from the company and should not be recovered in
18 | cash through rates.

19 | Q. Please explain your last point further.

20 | A. When a stock option or performance-based restricted stock is granted to a
21 | management employee, no cash is exchanged. The stock-related grant gives the receiver of
22 | the grant an option (right) to purchase stock at a discount from its market value at a future date.
23 | No cash is paid out by Empire at the time of the grant/option or when the employee exercises the

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1 grant/option to acquire Company stock. When the grant/option is exercised, the grant/option
2 holder pays cash to the Company and the Company issues stock. Empire does not pay out cash
3 to the grant/option holder at either point.

4 Q. Has the Commission previously expressed its view on appropriate rate treatment
5 of incentive plans?

6 A. Yes, in several instances. In the *Report and Order* issued in Case No.
7 GR-96-285, Missouri Gas Energy ("MGE"), the Commission stated the following regarding the
8 issue of incentive compensation plans that used shareholder-oriented financial measures:

9 The Commission finds that the costs of MGE's incentive
10 compensation program should not be included in MGE's
11 revenue requirement because the incentive compensation
12 program is driven at least primarily, if not solely, by the
13 goal of shareholder wealth maximization, and it is not
14 significantly driven by the interests of ratepayers.
15 5 Mo.P.S.C.3d 437,458 (January 22, 1997).

16 The Commission reiterated its position in its *Report and Order* in Case No. GR-2004-0209,
17 MGE:

18 The Commission agrees with Staff and Public Counsel that
19 the financial incentive portions of the incentive
20 compensation plan should not be recovered in rates. Those
21 financial incentives seek to reward the company's
22 employees for making their best efforts to improve the
23 company's bottom line. Improvements to the company's
24 bottom line chiefly benefit the company's shareholders, not
25 its ratepayers. Indeed, some actions that might benefit a
26 company's bottom line, such as a large rate increase, or the
27 elimination of customer service personnel, might have an
28 adverse effect on ratepayers.

29 If the company wants to have an incentive compensation
30 plan that rewards its employees for achieving financial
31 goals that chiefly benefit shareholders, it is welcome to do
32 so. However, the shareholders that benefit from that plan
33 should pay the costs of that plan. The portion of the

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1 incentive compensation plan relating to the company's
2 financial goals will be excluded from the company's cost of
3 service revenue requirement.

4 The Commission also addressed this issue in its *Report and Order* in Case No. ER-2006-0315,
5 Empire:

6 The Commission finds that the Staff reasonably applied
7 objective criteria for exclusion of certain incentive
8 compensation. The Staff disallowed compensation related
9 to charitable activities and activities related to the provision
10 of services other than retail electric service.... We
11 conclude that incentive compensation for meeting earnings
12 goals, charitable activities, activities unrelated to the
13 provision of retail electric service, discretionary awards,
14 and stock options should not be recoverable in rates.

15 The Commission also reiterated its position on incentive compensation matters in its *Report and*
16 *Orders* in Case Nos. ER-2006-0314 and ER-2007-0291, both KCPL rate cases.

17 Non-Executive Salaried Compensation

18 Q. In regards to the non-executive salaried employee incentive compensation
19 issue, is it true, as referenced in Mr. Beecher's rebuttal testimony at page 8, lines 6 to 8, that
20 "Staff excluded a portion of the non-executives that was associated with goals that Staff believed
21 benefited shareholders and not customers."?

22 A. Yes, this is correct. Similarly to the MIP as discussed above, in order to
23 determine the appropriate amount to include for the Department Head Cash Incentive Plan in
24 this case, Staff performed a review of all the incentive metrics used to measure each individual
25 goal and disallowed all the actual awards paid out to Empire's department heads associated
26 with performance measures tied to enhancing the value of the utility's stock price; i.e., earnings
27 per share.

1 Lightning Bolts

2 Q. Did Staff propose to disallow the expense associated with Empire's
3 "Lightning Bolt" awards?

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

5 Q. What is the reason for Staff's disallowance of Lightning Bolts?

6 A. Mr. Beecher states the Lightning Bolt Program provides cash awards to
7 individuals who deliver results beyond those normally associated with their position. However,
8 Lightning Bolts do not have any pre-set goals or objectives attached to them that employees can
9 "work toward," and are paid out at the senior management's discretion.

10 Q. What has been the Commission's past policy regarding incentives that do not
11 have any goals attached to them?

12 A. The Commission stated its position on this matter in its *Report and Order*,
13 page 49, in Empire's prior rate, Case No. ER-2006-0315:

14 The Commission finds that the Staff reasonably applied
15 objective criteria for exclusion of certain incentive
16 compensation. The Staff disallowed compensation related
17 to charitable activities and activities related to the provision
18 of services other than retail electric service. The Staff
19 disallowed the Lightning Bolts incentive compensation, as
20 they did not relate to the provision of electric service and
21 there were no performance criteria for receipt of the
22 awards; they were given solely at the Company
23 management's discretion.

24 Q. Does this conclude your surrebuttal testimony?

25 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric)
Company's Request for Authority to Implement) Case No. ER-2016-0023
a General Rate Increase for Electric Service)

AFFIDAVIT OF JERMAINE GREEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW JERMAINE GREEN and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing SURREBUTTAL TESTIMONY; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

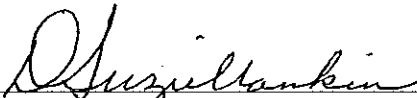


JERMAINE GREEN

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 16th day of May, 2016.

D. SUZIE MANKIN Notary Public - Notary Seal State of Missouri Commissioned for Cole County My Commission Expires: December 12, 2016 Commission Number: 12412070
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Notary Public