**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF JON R. EMPSON
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NOS. ER-2004-0034 AND HR-2004-0024 (CONSOLIDATED)**

Q. What is your name and position at Aquila Inc. ("Aquila")?

A. My name is Jon R. Empson, and I am currently the Senior Vice President, Regulated Operations.

Q. Are you the same Jon R. Empson that filed rebuttal testimony in this case?

A. Yes I am.

Q. What is the purpose of your surrebuttal testimony?

A. I will be addressing the rebuttal testimony on incentive compensation filed by Missouri Public Service Commission Staff ("Staff") Witness Dana E. Eaves.

Q. What position did Witness Eaves take on Aquila's incentive compensation expense?

A. Witness Eaves opposed the incentive adjustment based upon two major factors: (1) the proposed adjustment does not meet the "known and measurable" standard; and (2) measurement is based upon improper goals (platforms). (Eaves Rebuttal, page 10, lines 9 – 11)

Q. Did Aquila have an incentive plan for 2003?

A. Yes. Aquila had an employee variable compensation or incentive plan for 2003. All non-union U.S. employees were eligible for the variable compensation opportunity but Aquila's senior executives were not included.

Q. What is the status of the plan?

A. The achievement of personal objectives for each employee is being submitted to human resources. The incentives are scheduled to be paid in mid-March, 2004 for 2003 performance.

Q. How did Aquila accrue for the incentive payment in 2003?

A. The incentive plan is designed to have three potential payment levels based upon threshold, target and max achievements. Target is defined as the expected payment and is the level included in the accrual. If an employee meets the target performance, he/she would be eligible to receive 70% of the predefined variable compensation opportunity.

Q. Given that the deadline for inputting the personal goal achievements for the incentive plan was February 9, do you have any insights as to the level of achievement?

A. Yes. Human Resources has provided a summary, which indicates that for 205 eligible field employees supporting Aquila's electric operations in Missouri, the average achievement of personal goals was 86%. This means that the target is being exceeded. This amount is in excess of the target amounts requested in this rate case proceeding.

Q. Staff Witness Eaves cites Aquila, Inc's 10K Report to document the suspension of the 2002 incentive plan. Is his citation relevant?

A. No. The quote cited by Witness Eaves relates to Aquila's Long-Term Incentive Plan (LTIP) that was developed for key executives. The incentive plan expenses included in the rate case are for the annual incentive plan for employees and do not include any incentive payment for senior executives. While the LTIP was suspended through December 31, 2003, the annual incentive plan for the general employee population was re-instituted for 2003. As I indicated earlier in my testimony, we are in the process of calculating the incentive payouts at this time for payment in March. As recently as Tuesday, February 5, 2004, all Aquila managers were sent an email updating them about the incentive plan and the processing guidelines.

Q. Is there a possibility, as Witness Eaves states, that Aquila will not make incentive payments in 2004 for the 2003 plan?

A. No. The 2003 annual incentive payments will be made in March 2004. The reference Witness Eaves makes to the 10-K pertains to the LTIP, not the annual incentive.

Q. Are the incentive payments dependent upon Aquila achieving financial performance goals?

A. Witness Eaves has correctly identified the four criteria or organizational objectives that Aquila is using to fund the incentive plan: customer service, reliability, safety and effective use of capital. Witness Eaves has recommended that the effective use of capital objective be excluded from the incentive funding. Witness Eaves has ignored the rationale for having a portfolio of factors that fund the incentive pool, which create a natural check and balance. For example, the effective use of capital serves as a balancing factor for the operational and customer service metrics. Without a financial metric, operations could be incented to over-invest in order to ensure achievement of the operational metrics. On the other hand, appropriate levels of capital must be spent to support the achievement of the operational objectives. The funding metrics were purposely set this way to provide this natural balancing effect.

Q. Do you agree with Witness Eaves' recommendations?

A. No. The cases cited by Witness Eaves on page 14 of his testimony are not consistent with Aquila's method for funding the incentive plan. The cited cases used earnings and stock price objectives for determining incentive payments. Aquila is not using earnings or stock price to fund the plan but has instead focused on four key organizational objectives which include the effective use of capital in the utility business. While this is a financial measure, it is not the same type of measure that the Commission has determined in the cited cases to be inappropriate for determining incentive payments. Aquila wanted its employees to focus on how effective we were in spending both O & M and capital dollars and also how we were focusing on meeting the operational and customer service metrics. By including a financial measure in determining the level of incentive funding, Aquila is trying to optimize the use of dollars to benefit customers while minimizing potential interest expense for short and long-term debt to fund business operations. These are clearly direct benefits for our customers.

Q. Has Aquila maintained variable compensation plans in the past?

A. Yes. Staff Witness Eaves has only focused on the 2002 plan year's performance. Aquila and its divisions have maintained variable compensation plans since at least 1990 and prior. Since 1990, there has only been one plan year in which incentive payments have not been paid. That plan year was 2002, which corresponds with the test year in this case. The incentive compensation plan costs have been annual recurring costs dating back to 1990. By reviewing only one year of incentive compensation plan cost, the staff is conveniently ignoring one part of Aquila's two-part compensation system. The variable compensation plan represents ongoing cost levels that have occurred in the past and will be occurring on a going forward basis.

Q. Has the Staff proposed recovery of incentive payments in prior MPS rate case proceedings?

A. Yes. In Case No. ER-2001-672, Staff proposed recovery of all incentive payments made for team/personal goals of improving work performance. In addition, Staff witness Graham Vesely states the following in his surrebuttal testimony in Case No. ER-2001-672:

> The staff agrees in principle that incentive payments made for achieving goals of improved job performance that are of benefit to ratepayers should be recovered in utility rates. An incentive plan designed in such a manner promotes an organizational culture that is improvement-oriented and tied to individual employees' job performances, and one more likely to result in customers receiving value for their utility payments.

Q. How does his statement relate to the issues in this case?

A. Aquila's 2003 incentive compensation plan achieves exactly what Staff was supporting in this prior MPS rate case proceeding. Aquila's plan is based on key organizational objectives in which key metrics are measured which can be tied directly to improvements for our customers. Even the effective use of capital measurement objected to by Staff ensures that appropriate amounts of investment are occurring in utility infrastructure which ultimately benefits the service to our customers. Once the incentive plan is funded based on the key organizational objectives being achieved, employee's individual performances are measured to determine the ultimate incentive payment received. Thus, each individual involved in the incentive compensation plan is being motivated to improve his performance and achieve certain personal or departmental goals. Thus, an organizational culture that is improvement-oriented is being encouraged by the goals of the 2003 incentive compensation plan.

Q. Should the Commission accept Witness Eaves adjustments?

A. No. The variable compensation or incentive payments for 2003 were properly accrued in 2003, are going to be paid so they are known and measurable and are funded by meeting organizational objectives that benefit customers.

Q. Does this conclude your testimony?

A. Yes it does.