Exhibit No.
Issue: Management Incentive
Witness: Gene E. Bauer, Ph.D.
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District
Case No. ER-2006-0315

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

REBUTTAL TESTIMONY

OF

GENE E. BAUER Ph.D.

JULY 2006

REBUTTAL TESTIMONY
OF
GENE E. BAUER, Ph.D.
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2006-0315

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Gene E. Bauer, Ph.D. My business address is 2405 Grand, Suite 1200, Kansas City, MO 64108.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed with the Hay Group, Inc. as the Managing Director, United States.

Q. PLEASE DESCRIBE YOUR EDUCATION AND WORK BACKGROUND.

A. I graduated with honors from the University of Kansas. I earned my M.A. and Ph.D. degrees in Counseling Psychology from the University of Missouri in Columbia. I am also a member of Phi Beta Kappa.

During a four-year absence from Hay Group, I served as Vice President of Recruiting for The May Department Stores Company is St. Louis. My focus was the staffing of senior level executive positions throughout the nation for this $12 billion plus retailer. Prior to joining Hay Group, I was an Assistant Professor of Psychology at the University of North Carolina in Charlotte, North Carolina.

In my role of Managing Director, United States, I directly oversee the delivery of all consulting services to Hay Group clients in the United States.

I provide client management for consulting engagements and also consult directly with executive groups and boards of directors. I have over twenty-two years of consulting experience, with seventeen years of emphasis on executive compensation. I work with both publicly traded companies as well as privately held companies on executive compensation issues.

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes, I submitted testimony on behalf of The Empire District Electric Company ("Empire" or "Company") in Case No. ER-2004-0570.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS CASE?

A. I have prepared rebuttal testimony in response to the direct testimony of Commission Staff ("Staff") witness Amanda C. McMellen in regards to Staff's proposed treatment of executive, and salaried non-executive employee, pay. In my testimony, I will describe how the structure of Empire's executive compensation program was developed and how it compares to best practices. I will also explain why Staff's concept of separating the variable pay, the equity based compensation, and the cash salary is inaccurate and why all of these components should be included in test year expenses. Finally, I will describe how Empire's Discretionary Compensation Incentive Award programs for non-executive salaried employees were developed and how they compare to best practices.

Q. PLEASE PROVIDE AN EXECUTIVE SUMMARY OF YOUR REBUTTAL TESTIMONY.

A. My testimony shows that the compensation program in place at Empire for executive and salaried non-executive employees, which consists of both base and incentive compensation, is reasonable and prudent compared to best practices of companies both inside and outside the utility industry. I have concluded that the amount of total compensation paid to Empire's executives is reasonable compared to comparable companies so I recommend that the Commission approve that full amount for ratemaking purposes in this case. The compensation program that Empire's board of directors has put in place, which includes components of base salary, an annual award of bonus or incentive compensation, and long-term incentives for a select number of senior executives, reflects best practices of companies both inside and outside the utility industry. The program was developed with the aid of experienced compensation experts and was thoroughly reviewed by Empire's board of directors, which, through its Compensation Committee, is responsible for setting the Company's overall compensation policies and for administering its compensation plan.

Q. WHAT ADJUSTMENTS DID STAFF WITNESS MCMELLAN MAKE TO EXECUTIVE AND NON-EXECUTIVE PAY?

A. Ms. McMellan removed from test year expense several components of the overall compensation package. These adjustments removed the variable portion of the Company's executive compensation package for stock incentive pay and incentive pay and the incentive awards for non-executive salaried employees in the amount of $912,639.

Q. HOW IS COMPENSATION TYPICALLY DELIVERED TO EXECUTIVES IN COMPANIES SUCH AS EMPIRE?

A. The principal components of an executive's pay generally involve a mixture of base salary, an annual incentive, and a long-term incentive. The overall objective is to produce a compensation package that, in the aggregate, is reasonable and appropriate for the position and its duties. In addition, consideration should be given to the compensation of similar executives at comparable employers.

While a company certainly could develop a compensation program that allocates an executive's entire target pay amount to base salary, under that approach, all of the executive's pay would be fixed and none would be "at risk." Best practices in executive compensation seek to align the executive's interests with that of the employer and for the executive to receive a portion of his or her aggregate compensation package through variable pay. Under this approach, an executive receives a lesser amount when performance (based on whatever criteria are deemed appropriate by the person or group that makes compensation decisions – and in this case Empire's Compensation Committee) falls short of target levels and can receive a higher amount when performance exceeds target. Accordingly, employers typically develop executive pay programs that involve three components:

<u>Base Salary</u> – the amount paid periodically (e.g. twice per month) during the course of the year, generally subject to at least annual review;

<u>Annual Incentive or Bonus</u> – a single sum amount typically paid shortly after the end of the employer's fiscal year, based on any number of possible criteria which generally are related to employee and/or employer performance; and

<u>Long-term Incentives</u> – awards that encompass a multiple-year time horizon and that are designed to provide a targeted level of compensation if targeted objectives are achieved.

Q. HOW IS COMPENSATION TYPICALLY DELIVERED TO NON-EXECUTIVE SALARIED EMPLOYEES?

A. Pay programs for non-executive salaried employees typically include two of the three components found in executive compensation programs. These components are base salary and an annual incentive or bonus. As with executive compensation, the overall objective of non-executive pay is to produce a compensation structure that is reasonable and appropriate for the position and its duties. It has become increasingly important for salaried employees below the executive level to have a portion of their compensation include an annual incentive or bonus opportunity tied to the attainment of goals that further key company objectives. These goals target performance beyond the results typically contemplated for the employee’s position and, when accomplished, add significant financial, strategic, or cultural value to the company. Placing a portion of total compensation “at risk” to align the employee’s interests with those of the employer, and rewarding employees who make significant contributions to company success, are part of best practices in compensation design.

Q. WHAT EMPHASIS IS PLACED ON EACH OF THE THREE COMPONENTS OF EXECUTIVE PAY?

A. The particular emphasis placed on each of these pay vehicles varies depending on an employer’s specific facts and circumstances. However, the overall objective at any employer is to provide a total compensation package that accord with targeted levels. The effectiveness of any executive compensation package depends not only on the level of pay but also on the mix of the forms of pay. Thus, we have found that, rather than focusing solely on fixed compensation costs provided through base salary, a company also needs to develop an appropriate level of variable pay at executive levels.

Q. HOW DOES THE APPROACH USED BY EMPIRE IN COMPENSATING ITS EXECUTIVES COMPARE WITH BEST PRACTICES IN THE COMPENSATION FIELD?

A. Empire follows best practices in using a "three-legged stool" approach of base salary, annual performance-oriented incentives and long-term performance-based incentives to compensate its executives. The Compensation Committee of the Company's Board of Directors meets on a scheduled basis during the year and, with guidance and information furnished by Hay Group as its independent consultants, determines the targeted amount and form of the compensation of its executives.

Specifically, the Compensation Committee has established a compensation philosophy that targets a certain level for each of three categories of executive pay:

- Base salary – targeted at the 25th percentile;
- Total cash compensation (base salary plus annual incentive) – targeted at the 25th percentile; and
- Total direct compensation (total cash plus long-term incentives) – targeted at the middle point between the 25th and 50th percentiles.

The 25th percentile is the level at which the pay of an executive is (1) above 25 percent of comparable executives at other companies and (2) below 75% of comparable executives. Most companies target their executive pay components at the 50th percentile or higher; a significant number target the 75th percentile. By contrast, Empire targets substantially below the 50th percentiles in all three of these components of executive pay. In particular, base salary is targeted at only the 25th percentile.

At Empire variable compensation is a critical element of an executive's overall pay package. By building on the fixed pay provided by base salary, annual incentives are designed to focus executive behavior on tactical matters that support the Company's long-term vision. Rounding out the pay philosophy is the use of stock options as long-term incentives. The stock options are used to focus executive behavior on achieving Empire's vision.

Q. HOW DOES THE TOTAL AMOUNT OF COMPENSATION PAID TO EXECUTIVES DURING THE TEST YEAR COMPARE WITH COMPARABLE COMPANIES?

A. In comparing the total compensation of Empire's executives to peer companies, as well as the marketplace as a whole, it is my opinion that Empire's executive compensation levels are reasonable. By targeting the 25th percentile as its total cash compensation target, and the middle point between the 25th and 50th percentiles for its total direct compensation, Empire has established a very conservative program when compared to its peer group and the general market.

Q. HOW DOES EMPIRE'S COMPENSATION DESIGN PROGRAM FOR NON-EXECUTIVE SALARIED EMPLOYEES COMPARE WITH BEST PRACTICES IN COMPENSATION?

A. It is my opinion that Empire has established an appropriate process for constructing its compensation plan and making compensation decisions. This includes a systematic approach to job sizing, the utilization of multiple survey sources focusing on regional pay practices, and consultation with outside experts to determine appropriate levels and structure. Utilization of the regional marketplace as a comparator for non-executive salaried positions, as opposed to national comparators for executive positions, is an appropriate method of establishing and evaluating compensation levels. This is the case, in part, because the recruitment process to fill positions within this group of employee's will take place on a regional level. As this is the talent pool from which Empire will hire, it is common practice to utilize this same pool for benchmarking purposes.

Q. HOW DOES EMPIRE'S APPROACH TO COMPENSATING ITS NON-EXECUTIVE SALARIED EMPLOYEES COMPARE WITH BEST PRACTICES IN THE COMPENSATION FIELD?

A. Empire follows best practices in compensation structure for its non-executive salaried employees through linking its performance management systems with how employees are paid. This is achieved by allocating a percentage or fixed amount of an employee's compensation to a variable pay program tied directly to the attainment of goals and objectives set forth by management and aligned with the company's overall vision and business strategy. Operating in this manner will allow Empire to attract, retain, and motivate the type of talented employee that will benefit not only the company but the constituents it serves.

Q: HOW DOES EMPIRE'S COMPENSATION PHILOSOPHY COMPARE WITH COMPARABLE COMPANIES?

A: Examination of the compensation philosophy at Empire shows that the Company, in comparison with comparable employers, is quite conservative in its pay practices. In addition, Empire places a significant portion of executive pay at risk. In the rate-setting process, Empire should be commended for following these well-accepted best practices; it would be an unfortunate result if Empire were to be adversely affected in any rate-setting analysis for not front-loading an executive's targeted annual compensation into fixed base salary.

Q. WHAT WOULD BE THE CONSEQUENCES OF FOLLOWING THE RECOMMENDATION OF STAFF'S WITNESS MCMELLAN (STATED AT PAGE 14 OF HER TESTIMONY) THAT COMPENSATION UNDER THE DISCRETIONARY COMPENSATION INCENTIVE AWARDS PROGRAM CANNOT BE PLACED "AT RISK" AS A COMPONENT OF A VARIABLE PAY PLAN FOR NON-EXECUTIVE SALARIED EMPLOYEES?

A. Under the model advanced by Staff, all compensation for "normal" job duties must be made as fixed base salary. Operating in this manner prevents employers from designating key objectives to be met by the organization and structuring a compensation program to target the successful completion of these key objectives. Removing such an effective driver of performance and achievement may prevent an employer from operating as effectively and efficiently as possible. In Empire's case, through the use of performance criteria (whether based on individual goals for annual incentives or overall company goals), the Company utilizes carefully developed pay practices to provide conservative targeted pay levels.

Q: HOW SHOULD VARIABLE PAY OR EQUITY-BASED COMPENSATION BE TREATED IN DETERMINING EXECUTIVE COMPENSATION CONSIDERED FOR RATE-SETTING PURPOSES?

A. They should be treated the same.

Q. PLEASE EXPLAIN.

A: As discussed in answers to the preceding questions, the critical issue is whether an executive's total compensation package is reasonable and appropriate for his or her position and its duties, after considering the compensation of similar executives at comparable employers. By placing a significant portion of an individual's compensation in variable pay through annual and long-term incentives, Empire can focus attention on goals that are relevant to its overall success. These goals are carefully developed for each affected employee and coordinated in the pay programs. By having a portion of employees' pay at risk, Empire can better engage the efforts of employees towards achieving goals that are important to Empire in running its business.

Q. WHAT IS YOUR UNDERSTANDING AS TO HOW THE GOALS USED IN EMPIRE'S INCENTIVE PROGRAMS WERE ESTABLISHED?

A. I believe that the goals used in Empire's incentive programs were established by an active and knowledgeable Compensation Committee, with guidance and information provided by Hay Group as compensation consultants. Target levels of incentive compensation were established which must be earned through various performance criteria, including share price appreciation. Failure to attain target performance results in aggregate compensation at below-target levels. The performance-based measures used align an individual employee's interests with the goals of the Company to provide safe and reliable service at just and reasonable rates. Only when the goals are achieved does the individual receive his or her target compensation.

Q: STAFF WITNESS MCMELLEN APPEARS TO FAVOR AN APPROACH WHEREBY EMPLOYEES ARE COMPENSATED THROUGH THE USE OF

FIXED BASE SALARY TO THE EXCLUSION OF VARIABLE PAY. DO YOU AGREE WITH THIS APPROACH?

A: No. Debate over Empire's compensation programs could have been avoided through the inclusion within base salary of all of the amounts paid out under the incentive plans. Staff has approved base salary across the board, but resists approving variable pay for the achievement of goals the Staff opines are part of an individual's "normal job duties."

Q. COULD EMPIRE FOLLOW THIS APPROACH?

A. While Empire could obviously structure a compensation plan that consists solely of base salary, this would not be the right thing to do from a design standpoint.

Q. PLEASE EXPLAIN.

A. Variable pay is a primary component of a performance-based organizational culture. The negative impact from the removal of variable pay as a performance catalyst would likely be felt as strongly by ratepayers as it would by stockholders. Similarly, compensation design must carefully weigh upward adjustments to salary against the advantages of increased variable pay, as these adjustments will increase a company's fixed costs for salary expenses as well as the fixed costs associated with benefit and retirement programs that are tied to salary levels. In short, variable pay is a vital component within compensation design as it helps create and maintain a performance driven culture where management (or the Compensation Committee of the Board of Directors) can target the completion of key objectives, while at the same time allowing the company to compensate its employees at appropriate levels without unnecessarily increasing the fixed costs associated with base salary.

Q: ARE YOU AWARE OF ANY EXPERTISE POSSESSED BY THE STAFF THAT WOULD JUSTIFY ITS RECOMMENDED ELIMINATION IN THE RATE-SETTING PROCESS OF THE COMPENSATION PAYMENTS THAT WERE ESTABLISHED BY THE COMPENSATION COMMITTEE AND THAT YOU HAVE DISCUSSED?

A: No. I say this because to eliminate payment for activities and goals based on a belief that the activities are part of an individual's normal job activities displays a misunderstanding of basic pay concepts. In short, variable compensation is at risk and standards must be used to determine what portion is earned. Substantial deference should be given to the Compensation Committee's determination of the appropriate measures and goals. Similarly, it is the managerial province of the Compensation Committee, in developing compensation targets, to determine the extent to which an individual's pay-out is affected by results that exceed either the scheduled completion date or scheduled budget. Once again, the need for the Compensation Committee's setting of performance criteria is a function of placing a substantial portion of an individual's compensation in variable rather than fixed pay vehicles. Further, the Commission should be extremely circumspect and careful when asked to substitute its judgment for that of the Committee on what should be a goal for incentive compensation.

Q: STAFF WITNESS MCMELLEN HAS RECOMMENDED THAT THE COMMISSION EXCLUDE ALL EXPENSES ASSOCIATED WITH STOCK OPTIONS AND RELATED DIVIDEND EQUIVALENTS. DO YOU AGREE?

A: I do not agree. Staff has proposed an elimination of all expenses for stock options and related dividend equivalents. This appears to be based on the incorrect assumption that options (and dividend equivalents) constitute additional compensation without a corresponding benefit to Empire. However, as previously noted, stock options are a form of long-term compensation that is part of the executive's targeted pay package. When Empire determined to target "total direct compensation" (as defined above) at the middle point between the 25th and the 50th percentiles, much of the value of the compensation package to an executive purposefully was placed in the stock option grants and dividend equivalents. These option grants and dividend equivalents represent critical components of executive pay packages. Without these awards competitive market forces likely would have necessitated that Empire provide greater amounts in base salary and/or annual incentive pay. Accordingly, the Staff's proposed elimination of expenses for stock options and dividend equivalents was incorrect.

Q: WHAT ABOUT PERFORMANCE SHARE AWARDS?

A: Looking at performance share awards, the Staff did not include any costs for such performance shares. The Staff bases its position on a rationale that objects to the use of a total shareholder return ("TSR") measure and the comparison to pay at companies in the peer group developed for Empire. At the outset, this position indicates that the Staff believes it is better able to develop appropriate incentive measures than the Compensation Committee and its advisors. Apparently the Staff does not appreciate that the TSR measure is simply part of the variable pay component of an individual's compensation package and essentially is used to determine whether an employee receives his or her aggregate targeted compensation. Without performance shares, larger amounts would be needed in base salary or other component of total direct compensation.

The portion of the Staff's position that relates to the Company's use of peer group performance in pay determinations is addressed below in answers to specific peer group questions.

Q: WHY DOES EMPIRE EXAMINE PAY AT A PEER GROUP OF COMPANIES IN DEVELOPING APPROPRIATE PAY LEVELS?

A: The design of effective compensation programs requires balancing internal equity and external competitiveness to reward and retain top executive talent. In order to provide external equity, it is considered good practice to develop a comparator group of peer companies. Industry typically is a predominant factor in developing a peer group, especially in industries such as utilities. Specialized knowledge is required of executives within the utility industry, creating a limited pool of executive talent from which all utility companies recruit. Another important consideration in developing a peer group involves the size of the companies examined, with efforts made to use companies of similar size and use appropriate methodologies to account for any significant differences in size.

The use of peer groups creates a focus on external competitiveness both for compensation and business success. The practice helps with the recruitment, retention, reward and incentive of executive talent. A proper balance of internal equity and external competitiveness reduces the risk of losing senior management, thereby avoiding costly expenses for recruitment and lost productivity. In addition, the pricing of executive positions with respect to market considerations establishes an objective measure for comparison of compensation programs at different companies.

Q: WHAT IS THE COMMON METHODOLOGY IN DEVELOPING A PEER GROUP AND WAS THIS APPROACH USED BY EMPIRE?

A: The first step in developing an appropriate peer group involves identifying the job market(s) in which the company competes for talent. Specialized skills and knowledge are important considerations in the selection of a job market. The second step is to select companies within the identified job markets. Common criteria in selecting companies include size (such as revenues or, less commonly, assets) and business lines. The organization's needs and compensation strategy are considered in the development of the peer group.

Commonality of industry and size generally are the most important traits for an executive compensation peer group. Frequently, the peer group consists of a company's direct competitors for both talent and business. While geographic location sometimes is a factor in the selection of a peer group, it typically involves regional considerations and is rarely appropriate to limit to one state (such as Missouri, as apparently suggested by the Staff). Even a regional focus would be too restrictive in the utility industry, as a sufficiently large peer group would require the inclusion of companies that are not appropriate peers in size and industry and would result in the exclusion of otherwise similar companies. It would be inappropriate to distort pay comparisons by limiting the universe of potential peer companies to those that do business in Missouri when the best comparative companies operate outside of the state.

In selecting the peer group of companies used by Empire, Hay Group considered relevant factors, particularly industry and size considerations, and made recommendations to the Compensation Committee. Each of the companies in the peer group used by Empire are publicly traded utilities. The peer group companies are not confined to a particular region or state, but are located throughout the United States. The Staff's suggestion that the peer group must include companies located in Missouri, or that the geographic range should be limited to the Midwest region, would result in the inclusion of companies that are not appropriate peers in terms of size or industry and the exclusion of otherwise similar companies. While situations may exist in which it would be appropriate to limit peer companies by geographic considerations that is not the case here. For peer companies to provide relevant information to Empire, so that it may compare its executives' compensation to the marketplace, similarities of industry and size are the two most important considerations. Selecting peer companies from throughout the United States was thus an appropriate and reasonable decision in this instance.

Q: DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A: Yes.