Exhibit No: __________
Issue: Incentive Compensation
Witness: Gene E. Bauer, Ph.D.
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District
Case No: ER-2004-0570
Date: November 4, 2004

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

REBUTTAL TESTIMONY
OF
GENE E. BAUER, Ph.D.

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-2004-0570

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, Western U.S.

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 in 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, Western U.S., I directly oversee the delivery of all consulting services to Hay Group clients in Atlanta, Chicago, Dallas, Kansas City, and the West Coast.

I provide client management for consulting engagements and also consult directly with executive groups and Boards of Directors. I have over twenty years of consulting experience, with fifteen 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 Commission?

A. No, I have not.

Q. What is the purpose of your testimony?

A. I have prepared rebuttal testimony in response to the direct testimony of Commission Staff ("Staff") witness Sean T. Devore in regards to Staff's proposed treatment of executive pay. In my testimony, I will present how the structure of The Empire District Electric Company's ("Empire" or the "Company") executive compensation program was developed and 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.

Q. How is compensation typically delivered to executives?

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 annual 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) 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:

- Base salary – the amount paid periodically (e.g., twice a month) during the course of the year, generally subject to at least annual review;
- Annual incentive or bonus – 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
- Long-term incentives – 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. What emphasis is placed on each of these three components of executive's 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 percentile 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 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. Through the use of performance criteria (whether based on individual goals for annual incentives or overall company goals such as share price appreciation for stock options), Empire utilizes carefully developed pay practices to provide conservative targeted pay levels.

Q. Should variable pay or equity-based compensation be treated any differently than cash salary in determining compensation considered for rate-setting purposes?

A. No. 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.

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. The Staff of the Missouri Public Service Commission (the "Commission") apparently does not understand the use of variable pay and equity-based compensation since it attempts to distinguish them from other components of an executive's aggregate pay package. As previously noted, the incentive compensation design at Empire involved setting target levels of incentive compensation which must be earned through various performance criteria, including share price appreciation. Failure to attain target performance will result in aggregate compensation at below-target levels. The performance measures used are to help align an individual's interests with important goals of the Company. Only when the goals are achieved does the individual receive his or her target compensation.

Q. Does the Staff of the Commission possess sufficient expertise on compensation matters that would justify its recommended elimination in the rate-setting process of various payments that satisfy criteria established by the Compensation Committee?

A. Not in my opinion. Unlike the Compensation Committee and its independent consultants, the Staff of the Commission is not expert at compensation matters. 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 Devore has recommended that the Commission exclude all expenses associate with stock options and related dividend equivalents. Do you agree?

A. I do not agree. Staff's 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 25^{th} and the 50^{th} 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 of the Commission 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 selection of 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. All of the companies in the peer group used by Empire are publicly traded electrical utilities and they are of similar size. In summary, a reasonable and appropriate peer group was used by Empire for comparing the compensation of its executives to the marketplace.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.