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Compensation*
Witness: *Sean T. DeVore*
Sponsoring Party: *MoPSC Staff*
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Case Nos.: *ER-2004-0570*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

SEAN T. DEVORE

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

Jefferson City, Missouri
November 2004

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

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

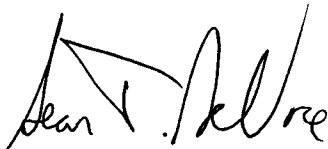
In The Matter of the Tariff Filing of The Empire)
District Electric Company to Implement a)
General Rate Increase for Retail Electric)
Service Provided to Customers in its Missouri)
Service Area.)

Case No. ER-2004-0570

AFFIDAVIT OF SEAN T. DEVORE

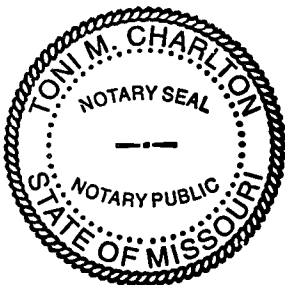
STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

Sean T. DeVore, being of lawful age, on his oath states: that he has participated in the preparation of the following surrebuttal testimony in question and answer form, consisting of 11 pages to be presented in the above case; that the answers in the following surrebuttal testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.



Sean T. DeVore

Subscribed and sworn to before me this 23RD day of November 2004.





Notary

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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OF
SEAN T. DEVORE

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SURREBUTTAL TESTIMONY

OF

SEAN T. DEVORE

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

Q. Please state your name and business address.

A. Sean T. DeVore, 1845 Borman Court, Suite 101, St. Louis, MO 63146.

Q. Are you the same Sean T. DeVore who previously filed direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Empire District Electric Company's (Empire, EDE or Company) witness Kelly S. Walters regarding Enron legal fees and Company witness Gene E. Bauer regarding incentive compensation.

ENRON LEGAL FEES

Q. Please briefly explain the issue.

A. Enron claimed that Empire owed a sum of money for future physical purchases of natural gas as a result of Empire's early termination of a fuel contract with Enron. Enron disputed the lawfulness of the termination. Empire terminated the contract due to the fall of Enron's credit rating. Empire and Enron eventually settled the dispute.

1 Staff has disallowed all legal fees pertaining to the Enron dispute, which was a one-time,
2 nonrecurring event.

3 Q. Please explain the Company's position on this issue.

4 A. The Company believes that specific legal fees are nonrecurring by nature
5 and that they should be allowed to recover these costs as a normal cost of doing business.

6 Q. Has Staff disallowed specific legal fees in the past?

7 A. Yes. The Staff consistently disallows not only specific legal fees, but
8 various other costs, due to the fact that such costs are nonrecurring and therefore, do not
9 represent an ongoing cost of service.

10 Q. Are these legal fees directly associated with other costs that are being
11 excluded from the cost of service?

12 A. Yes. As a part of the settlement, the Company agreed to pay Enron
13 \$1,000,000. This settlement, which was charged to fuel expense during the test year, has
14 been excluded from the ongoing annualized fuel expense proposed by both the Staff and
15 the Company. The Staff believes the legal fees directly associated with this settlement
16 should likewise be eliminated from the ongoing cost of service.

17 **INCENTIVE COMPENSATION PLAN (ICP)**

18 Q. Please explain the Company's position on this issue.

19 A. Mr. Bauer implies that the Company's ICP is simply the "at risk" portion
20 of its overall executive compensation. Mr. Bauer believes that the Company should be
21 able to recover all costs associated with incentive compensation in order to maintain a
22 total compensation package that is comparable to similar executives at comparable
23 employers.

1 Q. Please explain the Staff's position on this issue.

2 A. The Staff has made disallowances regarding the Company's executive
3 incentive compensation including the disallowance of a portion of the specific payments
4 for achieving goals, referred to as annual cash incentives, and all costs associated with
5 stock options. The Staff also has not included costs for performance shares awarded to
6 the executives and no expense was incurred during the test year.

7 Q. A summary of Empire's executive compensation philosophy is provided
8 on page 4, lines 19-23 continuing on page 5, lines 1-3 of Mr. Bauer's rebuttal testimony.
9 Does Staff agree with Mr. Bauer's comments?

10 A. The Staff believes that additional details related to Empire's executive
11 compensation targets are important in order to understand the targets. The Staff received
12 a copy of the Highly Confidential *Empire District Electric Company Executive*
13 *Compensation Review*, Discussion Draft, October 2003, Revised January 2004,
14 (Compensation Review) in response to Staff Data Request Number 437. I have attached
15 this report as HC Schedule 1 to my surrebuttal testimony. The targeted percentiles
16 selected for the three components of executive compensation, base salary, total cash
17 compensation (base salary plus annual incentive) and total direct compensation (total
18 cash compensation plus long-term incentives) are based on the HayGroup's Executive
19 Compensation Report of 700 (All-Exec Group) organizations across all industry sectors,
20 not the Peer Group Compensation Market (Peer Group) of twelve publicly traded
21 electrical utilities, referred to by Mr. Bauer in his rebuttal testimony. Explanations of
22 Empire's philosophy and a further description of executive groups that the targeted
23 percentiles are based upon are found on pages 3-4 of the Compensation Review.

1 Q. Does Mr. Bauer appear to agree with the Commission's Report And
2 Orders addressing the inclusion or exclusion of incentive compensation?

3 A. No. The Staff's incentive compensation position is based upon the
4 Commission's decisions in prior cases beginning with the Report and Order of Union
5 Electric Company (UE), Case Nos. EC-87-114 and EC-87-115, which states

6 At a minimum, an acceptable management performance plan
7 should contain goals that improve existing performance, and the
8 benefits of the plan should be ascertainable and reasonably related
9 to the incentive plan.

10 Q. How has the Staff applied this and other Commission decisions on
11 incentive compensation?

12 A. Improved existing performance anticipates that employees perform at a
13 level beyond their basic job requirements. Goals should be set to quantify specific job
14 performance that can be directly identified with the ICP. The goals should focus on
15 employee performance that can be associated with ratepayer benefits. The Commission
16 has been applying these criteria to the issue of incentive compensation for over seventeen
17 years. Most recently the Commission in its Report And Order for Missouri Gas Energy,
18 Case No. GR-2004-0209, affirmed its position: It states:

19 The Commission agrees with Staff and Public Counsel that the
20 financial incentive portions of the incentive compensation plan
21 should not be recovered in rates. Those financial incentives seek
22 to reward the company's employees for making their best efforts to
23 improve the company's bottom line. Improvements to the
24 company's bottom line chiefly benefit the company's shareholders,
25 not 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 adverse
28 effect on ratepayers.

29 If the company wants to have an incentive compensation plan that
30 rewards its employees for achieving financial goals that chiefly
31 benefit shareholders, it is welcome to do so. However, the

1 shareholders that benefit from that plan should pay the costs of that
2 plan. The portion of the incentive compensation plan relating to
3 the company's financial goals will be excluded from the
4 company's cost of service revenue requirement.

5 Q. Respecting page 7 of Mr. Bauer's rebuttal testimony, is the Staff's
6 disallowance of a portion of the annual cash incentives reasonable?

7 A. Yes, I relied on the following historical Commission standard regarding
8 incentive compensation: at a minimum, an acceptable management performance plan
9 should contain goals that improve existing performance, and the benefits of the plan
10 should be ascertainable and reasonably related to the plan. The Staff believes this is a
11 reasonable standard and has utilized it by allowing annual cash incentives for results that
12 were at or under budget and the incentive compensation was tied to a performance goal
13 respecting the budget. Allowing payments for budget-related goals that reward results
14 that are over budget, would be rewarding actions that do not improve existing
15 performance. The Staff takes the same approach respecting project deadlines, i.e., the
16 Staff disallowed cash incentives that were awarded for project completions beyond
17 completion dates.

18 Q. Has the Staff in fact been conservative in its treatment of the cash
19 incentives compared to the approach advocated by Mr. Bauer?

20 A. Yes. By disallowing payments for results that were over budget, the Staff
21 has correctly utilized the historical Commission standard. This is a conservative
22 approach particularly appropriate in the Empire case due to the fact that the Staff has
23 concerns regarding the use of budgets as performance indicators. The executives of
24 Empire receiving the incentives are the same individuals who approve the budgets that
25 are used as performance indicators for the cash incentives. There is an incentive to set

1 budgets at a level that can be achieved rather than at a level that represents true
2 improvement in performance.

3 Q. Respecting page 8 of Mr. Bauer's rebuttal testimony, please explain why
4 the Staff has disallowed the cost of stock options included in the executive long-term
5 incentive.

6 A. The Staff has disallowed the cost of stock options for several reasons. The
7 granting of these options is not associated with any increase in duties or achievement of
8 goals and no measurement of whether any specific level of performance was met or
9 exceeded. In addition, the triggering mechanism for these stock options is share price
10 appreciation. There are too many variables beyond the control of the individuals
11 receiving the incentives for this financial goal to be appropriate. Changes in share price
12 can result from changes in operating results, which in turn are affected by such items as
13 changes in weather and changes in fuel prices. The executives of Empire do not have any
14 control over the weather, wars or other disruptions in the world's oil and gas producing
15 countries, which affects fuel cost.

16 In addition to the above reasons, Empire is not required to expense its stock
17 options. Currently the Financial Accounting Standards Board (FASB) does not require
18 corporations to expense stock options. Corporations are only required to make a footnote
19 to their annual financial filings listing the value of the options. Empire's ratepayers
20 should not have to pay for the cost of stock options that the Company is not even required
21 to expense.

22 Q. Respecting pages 8 and 9 of Mr. Bauer's rebuttal testimony, why has the
23 Staff not included the cost associated with performance shares?

1 A. The triggering mechanism for awarding of the performance shares is total
2 shareholder return (TSR). The total shareholder return of Empire is compared to that of a
3 peer group chosen by the HayGroup. Since the triggering mechanism is total shareholder
4 return, the Staff believes that the cost of this benefit should be borne by the shareholder.
5 By using the performance of a peer group to determine an incentive award, the Company
6 has established criteria that are based on the financial performance of employees and
7 factors beyond Empire's control. There is no direct correlation between the financial
8 performance of the Peer Group of utilities and benefits to Empire ratepayers.

9 Q. Has the Company included any costs for executive long-term incentive
10 performance shares in its case?

11 A. No, it has not.

12 Q. Do you agree with Mr. Bauer when he states on page 7 of his rebuttal
13 testimony that the Commission and the Staff should show substantial deference to the
14 Compensation Committee's determination of the appropriate measures and goals?

15 A. No. Empire has the right to set employee base salary levels and develop
16 incentive compensation plans as it chooses. The determination of costs included in the
17 utility rates of Empire's Missouri ratepayers is the responsibility of the Commission and
18 the Staff has been given a role in the process by the Commission.

19 Q. Do you agree with Mr. Bauer's interpretation of your direct testimony
20 on page 8, lines 8-10 of Mr. Bauer's rebuttal testimony that you have assumed that stock
21 options and dividend equivalents, at executive compensation, provide no benefit to
22 Empire?

23 A. No, I do not. The Staff does not refute that a corresponding benefit to

Surrebuttal Testimony of
Sean T. DeVore

1 Empire shareholders associated with the executive long-term incentive stock options and
2 dividend equivalents may result. However, there is no support that these executive long-
3 term incentives benefit ratepayers. In fact, a detriment may result as executives focus
4 attention on maximizing their compensation based upon TSR.

5 Q. Please explain.

6 A. There are no goals associated with the executive long-term incentives
7 except for the TSR. The TSR measures stock price and dividends paid compared to the
8 Peer Group. There is no direct correlation between the financial performance of the Peer
9 Group of utilities and benefits to Empire ratepayers. Staff witness David Murray has
10 submitted direct, rebuttal and surrebuttal testimony on Empire's dividend policy and how
11 it can be detrimental.

12 Q. Does Empire rely on the Peer Group to determine its targets for base
13 salary, total cash compensation or total direct compensation?

14 A. No. Please refer to my HC Schedule 1, pages 3-4.

15 Q. What is the relevance of Mr. Bauer's rebuttal testimony, pages 9-11,
16 respecting the value of peer groups?

17 A. None. The Peer Group was only used by the HayGroup and Empire as a
18 trigger for the awarding of long-term incentive performance shares based upon the TSR.
19 While the Compensation Review includes data related to the Peer Group as a gauge to
20 compare to the All-Exec Group, Empire's targets are based upon the All-Exec Group of
21 700 organizations.

22 Q. Does the Staff agree with Mr. Bauer's representation of the Peer Group?

1 A. Mr. Bauer's general representation of peer groups appears on the surface
2 to be reasonable, yet the details specific to Empire's selected Peer Group do not support
3 his conclusions. Please refer to HC Schedule 1, Appendix B of my surrebuttal testimony
4 where comparative financial information of the Peer Group utilities is provided. On
5 page 10, lines 20-21 of Mr. Bauer's rebuttal testimony, he states, "Commonality of
6 industry and size generally are the most important traits for an executive compensation
7 peer group." The Staff would agree that these traits are important but the Peer Group
8 selected for the HayGroup analysis and approved by Empire's Compensation Committee
9 does not appear to be the best fit for comparisons to Empire.

10 Several of the Peer Group utility companies are considerably larger than Empire.
11 If size is relative to total assets, the largest Peer Group company has over \$3 billion in
12 total assets compared to Empire's \$970 million. If size is relative to total revenues, the
13 largest Peer Group company has over \$1.1 billion in total revenues compared to Empire's
14 \$306 million. It is not surprising that the Peer Group utility company with the largest
15 chief executive officer total direct compensation (\$1.9 million) also has assets and total
16 revenues well in excess of Empire's. The Staff would also emphasize that the Peer Group
17 analysis does not appear to support either annual incentives or long-term incentives for
18 all executives. HC Schedule 1, Appendix A shows that for the selected comparable
19 executive positions, there are utility companies within the Peer Group that do not have
20 annual incentives and/or long-term incentives.

21 The Staff's review of Peer Group utility company public information also
22 indicates that the mix of regulated to nonregulated business activity, region of the country
23 in which the utility company operates and corporate structure make comparisons to

1 Empire less appropriate. The Staff prefers comparisons to utility companies within the
2 Midwest region and Missouri be included in peer groups and that cost of living
3 adjustments to total direct compensation be made for executives located in urban areas.

4 Q. Has the Staff performed an analysis on Empire's executive compensation
5 or management incentive plan (MIP) in prior cases?

6 A. Yes. The Staff documented the base salaries and MIP expenses in Empire
7 Case Nos. ER-97-81, ER-2001-299 and ER-2002-424 and consistently applied the
8 Commission's guidelines.

9 Q. Has the disallowance of MIP expenses been a contested issue in any of
10 these cases before the Commission?

11 A. No. While another Empire ICP was contested by the Staff and Empire in
12 Case No. ER-2001-299, the Staff's MIP disallowance was not contested by Empire.

13 Q. Is the Staff opposed to the recovery of any incentive compensation in rates
14 and there being an "at risk" portion of executive pay as stated by Mr. Bauer on pages 6-7
15 of his rebuttal testimony?

16 A. No. The Staff is not generally opposed to there being a portion of
17 executive compensation at risk. If it can be shown that the results provide ratepayer
18 benefits, the Staff would include these costs for recovery in its cost of service.

19 Q. Does Mr. Bauer indicate that Empire's MIP changed recently?

20 A. No. Prior to Empire's last rate case the executives' incentive
21 compensation consisted of a lump-sum cash incentive and each executive received a
22 small number of restricted stock awards. In 2001, Empire adopted its current executive
23 incentive compensation plan. The current executive incentive compensation plan keeps

1 the lump-sum cash incentives, while the number of stock options has considerably
2 increased. Each executive is now also awarded performance shares. Mr. Bauer claims
3 on pages 9-10 of his rebuttal testimony that the total compensation package, structured at
4 about the 25th percentile of the executives at similar companies comprising the Peer
5 Group, will help recruit future executive talent and retain the current executive talent.
6 Empire targets its executive total direct compensation based on the All-Exec Group of
7 700 organizations across all industry sectors, not the Peer Group. (HC Schedule 1,
8 pages 3-4).

9 Q. Is the Staff aware of any executive retention problem at Empire?

10 A. No. The executives that are currently at Empire have held other positions
11 at Empire before working their way up into their current executive positions. Two of the
12 five executives left Empire for a short period of time when it was anticipated that if the
13 Aquila merger occurred, their positions would be eliminated. Both of these executives
14 returned when the merger failed. There is no indication that Empire has any recruitment
15 or retention problems.

16 Q. Does this conclude your surrebuttal testimony?

17 A. Yes, it does.

SCHEDULE 1
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IN ITS ENTIRETY