Exhibit No.:	
Issues:	*Legal Fees; Incentive Compensation*
Witness:	*Sean T. DeVore*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case Nos.:	*ER-2004-0570*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

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Missouri Public
Service Commission

SURREBUTTAL TESTIMONY

OF

SEAN T. DEVORE

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

Jefferson City, Missouri
November 2004

NP

Denotes Highly Confidential Information

Exhibit No. 38NP
Case No(s). 12-06-04 KF
Date ER-2004-0570 Rptr KF

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	)	
	)	ss.
COUNTY OF COLE	)	

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

Sean T. DeVore

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

Toni M Charlton

Notary

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

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

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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.

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

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

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

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

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

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

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

INCENTIVE COMPENSATION PLAN (ICP)

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

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

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

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

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

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

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

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

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

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

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

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the

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

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

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

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

A. Yes. By disallowing payments for results that were over budget, the Staff has correctly utilized the historical Commission standard. This is a conservative approach particularly appropriate in the Empire case due to the fact that the Staff has concerns regarding the use of budgets as performance indicators. The executives of Empire receiving the incentives are the same individuals who approve the budgets that are used as performance indicators for the cash incentives. There is an incentive to set budgets at a level that can be achieved rather than at a level that represents true improvement in performance.

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

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

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

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

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

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

A. No, it has not.

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

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

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

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

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

Q. Please explain.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. No. Prior to Empire's last rate case the executives' incentive compensation consisted of a lump-sum cash incentive and each executive received a small number of restricted stock awards. In 2001, Empire adopted its current executive incentive compensation plan. The current executive incentive compensation plan keeps the lump-sum cash incentives, while the number of stock options has considerably increased. Each executive is now also awarded performance shares. Mr. Bauer claims on pages 9-10 of his rebuttal testimony that the total compensation package, structured at about the 25th percentile of the executives at similar companies compromising the Peer Group, will help recruit future executive talent and retain the current executive talent. Empire targets its executive total direct compensation based on the All-Exec Group of 700 organizations across all industry sectors, not the Peer Group. (HC Schedule 1, pages 3-4).

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

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

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

SCHEDULE 1

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