COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

Application Of Kentucky Power Company For:	**)**	
(1) A General Adjustment Of Its Rates For Electric	**)**	
Service; (2) An Order Approving Its 2014	**)**	
Environmental Compliance Plan; (3) An Order	**)**	**Case No. 2014-00396**
Approving Its Tariffs And Riders; And (4) An	**)**	
Order Granting All Other Required Approvals	**)**	
And Relief	**)**	

REBUTTAL TESTIMONY OF

ANDREW R. CARLIN

ON BEHALF OF KENTUCKY POWER COMPANY

VERIFICATION

The undersigned, Andrew R. Carlin, being duly sworn, deposes and says he is the Director, Compensation and Executive Benefits for American Electric Power Service Corporation and that he has personal knowledge of the matters set forth in the forgoing testimony and the information contained therein is true and correct to the best of his information, knowledge and belief.

Andrew R. Carlin

Andrew R. Carlin

STATE OF OHIO)
) Case No. 2014-00396
COUNTY OF FRANKLIN)

Subscribed and sworn to before me, a Notary Public in and before said County and State, by Andrew R. Carlin, this the 27th day of April 2015.

Notary Public

NOTARIAL SEAL STATE OF OHIO

MARTIN ROSENTHAL
Attorney at Law
Notary Public, State of Ohio
My Commission Has No Expiration
Section 147.03 R.C

My Commission Expires

REBUTTAL TESTIMONY OF
ANDREW R. CARLIN
KENTUCKY POWER COMPANY
BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

Q. PLEASE STATE YOUR NAME.

A. My name is Andrew R. Carlin.

Q. ARE YOU THE SAME ANDREW R. CARLIN WHO OFFERED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to correct mischaracterizations in the testimony of Ralph C. Smith on behalf of the Kentucky Attorney General's (AG) office and Lane Kollen on behalf of the Kentucky Industrial Utility Customers (KIUC) with respect to compensation expenses included in the Company's filing. I will show that the incentive compensation expenses in question provide substantial benefits to customers and, as such, should be included in the revenue requirement without reduction.

Q. WHAT ADJUSTMENTS HAVE BEEN PROPOSED WITH RESPECT TO THE COMPANY'S REQUESTED LEVEL OF ANNUAL INCENTIVE COMPENSATION EXPENSE?

A. KIUC witness Kollen proposes denying rate recovery for 100% of Long Term Incentive Plan (LTIP) expense. AG witness Smith also proposes denying 100% of LTIP expense and further recommends denying substantial employee payroll costs by eliminating 75% of the Annual Incentive Compensation Plan (AIP) expense.

Q. DO YOU AGREE WITH EITHER OF THESE RECOMMENDATIONS?

A. No, for the many reasons cited below and those substantiated in my direct testimony.

Q. IS THE TOTAL COMPENSATION PACKAGE OPPORTUNITY PROVIDED TO EMPLOYEES (WHICH INCLUDES AIP AND LTIP EXPENSE) AT OR BELOW MARKET COMPETITIVE LEVELS?

A. Yes. In my direct testimony I demonstrated that the Companies' total employee compensation was market competitive and not excessive (Company Witness Carlin Direct, p. 13-18 and Company Exhibits ARC- 2, ARC-3, and ARC-4). These market compensation analyses show that total compensation package provided to the Companies' employees, including executive positions, was at or below market. Additionally, for approximately 12 Craft and Technical positions, 25% were determined to be 10% or more below the market competitive range on average. In fact, without variable incentive compensation, 83% of these positions would be 10% or more below market wages (ARC-2).

In fact, no concerns have been raised by any party in this case with respect to the reasonableness or market competitiveness of the Companies' total compensation levels which include the variable AEP and LTIP amounts. The only concerns that have been raised are related to whether customers or shareholders should pay for certain variable components of this compensation package, irrespective of whether the Companies' compensation in its entirety is a reasonable, prudent and necessary cost of doing business, which has not been challenged.

Q. HOW WOULD THE COMPANY BE AFFECTED BY REDUCING OR ELIMINATING VARIABLE INCENTIVE COMPENSATION FROM ITS COST OF SERVICE FOR RATEMAKING PURPOSES?

A. Denying cost recovery for a portion of the variable component of employee pay would reduce the Company's rate of return to below the level to be set in this rate case, all else being equal. It would also encourage shifting variable incentive compensation into fixed base pay to enable the Company to recover these payroll costs. The Companies would need to continue to offer employees this compensation, in one form or another, in order to continue to maintain compensation at the market competitive levels needed to attract and retain employees with the skills and experience needed to efficiently and effectively conduct its business for the benefit of customers.

Transferring variable incentive compensation into fixed base pay would likely lead to the gradual erosion of the efficiencies and benefits gained by the proven strategy of linking pay to performance. (Company Exhibit ARC-D6). The loss of these efficiency and productivity gains, as well as the many other benefits which incentive compensation provides to customers, employees, and other stakeholders, and would lead to increased expenses in other categories, reduced company performance in many areas and higher rates for customers. Therefore, these proposals offered by the KIUC and AG should be rejected by the Commission.

Q. DOES KIUC ALSO PROPOSE REDUCING EMPLOYEE COMPENSATION EXPENSE BY ELIMINATING 75 PERCENT OF ANNUAL INCENTIVE EXPENSE AS PROPOSED BY AG WITNESS SMITH?

A. No. It is likely that, as with nearly all U.S. industrial companies, KIUC constituents heavily utilize annual incentive compensation and understand the benefits it provides to all company stakeholders, including customers.

Q. WHAT JUSTIFICATIONS ARE CITED BY AG WITNESS SMITH FOR EXCLUDING 75% OF THE ANNUAL INCENTIVE COMPENSATION?

A. Mr. Smith cites the 75 percent funding measure tied to AEP's earnings per share and prior Commission orders in cases with significantly different facts. The Commission's view in those dissimilar cases was that incentive compensation tied to financial performance measures primarily benefits shareholders and that the Commission was unconvinced that ratepayers benefit sufficiently to support recovery of this cost through rates.

Unlike these previous cases, the Company has shown that its incentive compensation program is a critical component of market competitive total compensation that benefits customers by enabling the Companies to attract and retain the employees needed to efficiently and effectively provide its service to customers. Neither the need for market competitive total compensation nor the appropriate level of such compensation is contended in pre-filed testimony in this case. Furthermore, these previous cases do not address the distinction between funding measures, which AEP uses to assure that overall annual incentive compensation payouts are affordable at the parent company level, and performance measures, which actually incentivize employee performance. Unlike the funding measures, performance measures provide an incentive to employees because there is a line of sight between their personal performance and their award payout.

Q. DOES TYING A PORTION OF ANNUAL INCENTIVE COMPENSATION TO FINANCIAL PERFORMANCE PRIMARILY BENEFIT SHAREHOLDERS?

A. No. “The objectives of AEP’s Annual Incentive Compensation Plan (the Plan) are to:

- Attract, retain and motivate employees to further the objectives of the company, its customers and the communities it serves;
- Enable high performance by establishing, communicating and aligning employee efforts with the Plans performance objectives; and

- Foster the creation of sustainable shareholder value through achievement of AEP's goals."[1]

The first two of these directly benefit customers. Attracting, retaining and motivating employees, in whom the Company has made a significant investment, benefits customers by avoiding the costs associated with high turnover and low productivity. This benefit to customers is not diminished by tying a portion of plan funding to AEP's earnings. Because the primary, and often only lever, most employees have in a regulated utility to meet financial objectives is cost efficiency, tying incentive compensation to financial objectives directly benefits customers by providing an incentive that promotes efficiency. Furthermore, the robust nature of this and other rate case proceedings mitigates the risk that employees will be unduly motivated by such earnings measures to pursue rate increases at the expense of rate payers.

Furthermore, the customers already receive, and will continue to receive in connection with this filing the accumulated benefits from past incentive compensation arrangements. Annual incentive compensation is not a limitless productivity engine that generates incremental productivity gains each and every year sufficient to offset the reasonable, prudent and necessary costs that witness Smith proposes to deny. Denying this cost would provide all the accumulated benefits to customers without most of the corresponding payroll cost that sustain and build on these efficiencies. Such an approach is unreasonable and unbalanced.

Next, providing market competitive compensation through base pay alone would not align the interests of employees with those of customers and shareholders. Doing so would fully insulate employees from economic volatility, which would push their share

[1] American Electric Power Annual Incentive Compensation Plan, p. 1.

of such volatility onto both shareholders and customers. It is largely for this reason that many employers including government entities are moving from defined benefit contribution plans, in which the employer takes the investment risk, to the defined contribution plans, in which the employee takes the investment risk.

Finally, Mr. Smith's testimony seemingly is based on the unfounded assumption that the Company's customers have no interest in the Company's financial performance. Earnings that approach the Company's authorized rate of return allow Kentucky Power to stay out longer between rate cases and provide rate stability. A company whose employees who have a clear financial incentive strive to cut costs, to improve efficiencies, to manage risk, and to respond to change likewise is less likely to need to seek a rate adjustment.

Q. DO YOU AGREE THAT THE COMPANIES' ANNUAL INCENTIVE COMPENSATION IS WEIGHTED TO FINANCIAL GOALS?

A. No. AG Witness Smith inappropriately focuses on funding measures while ignoring the actual performance measures in the Company's annual incentive program. The majority of KPCO employees participate in the American Electric Power Annual Incentive Compensation Plan for AEP Utilities with many Kentucky Power Company (KPCO) specific performance measures (See 2014 KPCO specific performance measures below).

<u>Infrastructure Development (30%)</u>
KPCO Net Income (15%)
KPCO Capital and O&M Spending and Reallocation (10%)
KPCO / AEP Utilities Economic Development (5%)
<u>Customer Experience (25%)</u>
Customer Reliability – KPCO SAIDI (25%)
<u>Employee Experience (35%)</u>
KPCO Employee Culture Work Plan Execution (10%)
KPCO Employee Severity Rate (7.5%)
KPCO Employee Incident Rate (7.5%)
KPCO Contractor Incident Rate (5%)
KPCO Preventable Vehicle Accident Rate (5%)
<u>Strategic Initiatives (10%)</u>
Mitchell Transfer - Implement all aspects of the commission approved stipulation and settlement agreement (5%)
Capital Investment Financing - Develop a strategy with local banks to secure future financing for capital investments in Kentucky Power's electric system assets (5%)

Only one of the performance measures in this plan, the KPCO Net Income (15%) measure, is a financial measure.

The funding measures in AEP's incentive compensation program ensure that the overall amount of annual incentive compensation is affordable for AEP as a whole. Because Kentucky Power Company is a small portion of AEP in total, the 75 percent net income funding measure provides little incentive for employees to seek greater cost recovery through Kentucky Power rates. The KPCO specific performance measures above are the focus of the annual incentive program for KPCO distribution employees and, as such, are the measures that drive KPCO performance.

Q. ARE THERE ANY OTHER REASONS WHY YOU DISAGREE WITH AG WITNESS SMITH?

A. Yes. It is not proper for the companies to "charge" employee compensation costs to shareholders when this compensation is a reasonable, prudent and necessary expense for the Companies. Mr. Smith erroneously infers that shareholders are the main beneficiaries of the funding pool, when it is simply a mechanism to provide goal oriented variable compensation which directly encourages employees to reduce expense, and operate safely and efficiently to provide reliable service to Kentucky Power customers. Stated otherwise, Mr. Smith's objection to the form of the Company's compensation arrangements, but not its reasonableness otherwise, is literally a matter of form over substance.

Q. WOULD THE COMPANY BE FINANCIALLY HARMED IF THE COMMISSION ADOPTED AG'S PROPOSAL ON ANNUAL INCENTIVE COMPENSATION?

A. Yes. The Companies' would need to continue to provide annual incentive compensation to all employees, or a base pay equivalent in order maintain the market competitive compensation levels needed to attract and retain the qualified and appropriately experienced employees it needs to efficiently and effectively provide service to customers. Unless cost recovery is provided in rates for this substantial expense, the Company will not have a reasonable opportunity to earn the rate of return authorized in this proceeding. As established in my direct testimony, the expense associated with annual incentive program is necessary because the Companies' total compensation program would not be market competitive if it was eliminated without providing an approximately equal offsetting increase in base pay. Likewise, reducing the statistical expected payout of annual incentive compensation would lead employees to discount its value accordingly when considering other employment opportunities. As established in my direct testimony, the overall value of the Companies' total compensation package would fall well below market competitive levels without the annual incentive compensation portion of employee pay. This is undisputed in pre-filed testimony in this case.

Furthermore, it is not reasonable to expect that the incremental benefit that annual incentive compensation may produce between rate cases, if any, will be sufficient to cover the 75 percent of incentive compensation that witness Smith proposes denying. As a fundamental matter, it is important to recognize that the Company's incentive compensation plan has no incremental cost above the cost of providing market competitive compensation. Annual incentive compensation has encouraged and supported the development of a culture of high performance within the Companies over the nearly two decades it has been in place for all employees. The efficiency gains and other benefits that have resulted from incentive compensation and this high performance culture will already be incorporated in rates through this and prior rates case proceedings. It is not reasonable to expect that additional efficiency gains and other cost savings equivalent to 75 percent of the cost of annual incentive compensation will be achieved going forward through the use of incentive compensation. Because it has been in place for such a long period, only small, incremental benefits, if any, should be expected from incentive compensation going forward. However, even if incentive compensation only produces small incremental benefits or no new benefits going forward, it will still provide a positive net benefit because it has no incremental cost above the cost of providing market competitive compensation through base pay alone and because it helps maintain the efficiency gains and other cost savings that have already been achieved.

Q. WHAT IS YOUR RECOMMENDATION WITH RESPECT TO AG'S PROPOSAL TO REDUCE EMPLOYEE COMPENSATION EXPENSE BY ELIMINATING COST RECOVERY FOR 75% OF ANNUAL INCENTIVE EXPENSE?

A. I recommend that the Commission reject AG witness Smith's proposal to eliminate three quarters of direct employees' and AEPSC employees' annual variable incentive opportunity from cost of service. This is a necessary expense that is properly included as market competitive employee compensation and a reasonable and prudent cost of providing service to our customers.

Q. WHAT JUSTIFICATIONS ARE CITED BY AG WITNESS SMITH FOR EXCLUDING 100% OF STOCK-BASED COMPENSATION?

A. First Mr. Smith states his philosophical belief that "ratepayers should not be required to pay executive or director compensation that is based on the performance of the Company's (or its parent company's) stock price, or which has the primary purpose of benefitting the parent company's stockholders and aligning the interests of participant with those of such stockholders." Mr. Smith also points out that stock option expense, which the Companies do not have, was at one point treated as a dilution of shareholder's investments. Despite the facts that this is no longer the case and the Companies' stock-based compensation has never been treated in the same fashion as stock option expense, He believes that "this does not provide a reason for shifting the cost responsibility for stock-based compensation from shareholders to utility ratepayers."

Q. DO YOU AGREE WITH AG WITNESS SMITH?

A. No. There are several mischaracterizations in his testimony and I disagree with both his philosophical view and recommendation. The first mischaracterization is that the Companies only provide stock-based compensation to executives and directors, which is not the case. In the test year the Companies included stock-based compensation as a variable part of their total compensation package to approximately 650 employees, which exceeds any reasonable definition of executives and company directors. In 2015 the number of long-term incentive participants whose pay includes this variable portion was increased to approximately 950 employees.

The second mischaracterization is that stock-based compensation is based on the performance of the Company's (or its parent company's) stock price. Unlike stock options, which have no value unless the underlying stock price increases in value, the Companies' stock-based compensation has a value on day one. While the parent Company's stock price is one of several factors that determine the value of this compensation for participants, the amount the Company has requested be included in cost of service is a static value that is unaffected by stock price changes, earnings and all other factors. Shareholders will gladly accept responsibility for any compensation associated with improvements in stock price and earnings provided customers accept responsibility for the cost associated with static portion of employee compensation, in all forms, that is part of a market competitive compensation package.

Lastly, Mr. Smith mischaracterizes the Companies' current stock-based compensation program by associating it with stock options, which the Companies last granted in volume to a much smaller population in 2003. Stock options and the Companies' current forms of stock-based compensation are different instruments, with different accounting, granted in different periods in different volumes to different populations. Denying the Companies' current stock-based compensation as the result of such a comparison is unreasonable.

Q. WHAT JUSTIFICATIONS ARE CITED BY KIUC WITNESS KOLLEN FOR EXCLUDING 100% OF STOCK-BASED COMPENSATION?

A. Witness Kollen misrepresents the Companies' stock-based employee compensation program and goals, stating that;

> "The Commission precedent is to remove incentive compensation expenses from the revenue requirement if the expenses incentivize financial performance to achieve shareholder goals, not customer goals. The AEP LTIP incentive compensation expense is incurred to achieve shareholder goals and is not directly tied to the achievement of regulated utility serve requirements. In fact, the AEP LTIP benefits shareholders to the detriment of customers in rate proceedings such as this."

Witness Kollen further that indicates that "the Commission has long held that ratepayers receive little, if any, benefit from these types of incentive plans." Lastly, witness Kollen points to what he argues is an inherent conflict between lower rates to customers and greater financial performance for shareholders and incentive compensation for executives and other employees.

Q. DO YOU AGREE WITH AG WITNESS KOLLEN?

A. No. First, recommendations in any rate case proceeding should stand on the testimony and exhibits in evidence in the particular case, not orders from other cases, as is required by the Kentucky Public Service Commission. Unlike previous cases, the Company has shown that its long-term incentive compensation is a critical component of market competitive total compensation that benefits customers by enabling the Companies to attract and retain the employees needed to efficiently and effectively provide its service to customers. Neither the need for market competitive total compensation nor the appropriate level of such compensation is contended in pre-filed testimony in this case.

Secondly, witness Kollen portrays a false dichotomy by suggesting that the Companies' long term incentive program incentivizes the achievement of shareholder but not customer goals. The primary objective of the Companies' long-term incentive plan is to provide the market competitive compensation needed to attract, retain and motivate the appropriately skilled and experienced employees that is needed to efficiently and effectively provide electric service to customers. This fundamental aspect of the plan clearly benefits both customers and employees. Furthermore, the financial measures included in the performance unit portion of the Companies' long-term incentive compensation (70% of the total) benefit customers by providing an incentive to control costs, which is the only lever most utility employees have available to improve company financial performance.

The remaining 30% of AEP's long-term incentive program is tied primarily to participant retention through vesting requirements and is not tied to any performance measures.

The belief that long-term compensation benefits shareholders to the detriment of customers in rate proceedings, by encouraging company employees to seek unwarranted rate increases, ignores the robust nature of such proceedings and questions the effectiveness of this and other Commissions.

My testimony shows that the Companies' long-term incentive compensation plan provides substantial benefits to customers by enabling the company to provide market competitive compensation that enables it to attract and retain suitable employees, by encouraging cost control and by encouraging employee retention. These benefits certainly exceed the $0 incremental cost of long-term incentive compensation relative to the cost of providing market competitive compensation through other types of compensation alone.

Q. ARE THERE ANY OTHER REASONS THAT STOCK-BASED COMPENSATION SHOULD BE INCLUDED IN THE COMPANY'S COST OF SERVICE.

A. Yes, as with annual incentive compensation, each rate case conveys all of the benefits that have accumulated over the many years that the Company's stock-based compensation has been in place, to customers. And as was further the case with annual incentive compensation, Mr. Kollen's proposal provides customers with the accumulated benefits of the stock-based compensation arrangements but none of the costs.

In addition, AEP's long-term incentive compensation is intended, as the name implies, to encourage participants to consider the long-term impact of their decisions on AEP and all of its stakeholders, including current and future customers. The long-term incentive program also serves as a way of compensating employees for performance that often has significant benefits to customers, for example, by designing new equipment and procedures in house, and thus avoiding the cost of much more expensive outside contractors and consultants.

Again, without a market competitive total compensation program that includes either long-term incentive compensation or some other form of compensation of equal value, the Companies cannot successfully compete for appropriately skilled and experienced personnel. Therefore, as previously shown (Carlin Direct, p.31) and provided in exhibits, providing market competitive employee compensation to employees at all levels of the organization is a necessary and basic cost of providing utility service to our customers. This is particularly true at leadership levels where management continuity is often critical. Simply put, no company of AEP's size and complexity can function effectively without highly skilled people to lead it.

Q. WHAT IS YOUR RECOMMENDATION WITH RESPECT TO INTERVENOR'S PROPOSALS TO ELIMINATE THE STOCK UNIT PORTION OF EMPLOYEE LONG-TERM INCENTIVE COMPENSATION?

A. I recommend that the Commission reject AG witness Smith's and Kollen's proposals. As demonstrated previously, this long-term variable portion of employee pay simply is an incentive opportunity that brings employee compensation to market competitive rates.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.