

APR 20 2012

by  
State Corporation Commission  
of Kansas

IN THE MATTER OF THE APPLICATION OF MID- )  
KANSAS ELECTRIC COMPANY, LLC FOR APPROVAL )  
TO MAKE CERTAIN CHANGES IN ITS CHARGES FOR ) DOCKET NO.  
ELECTRIC SERVICES IN THE GEOGRAPHIC SERVICE ) 12-MKEE-380-RTS  
TERRITORY SERVED BY SOUTHERN PIONEER )  
ELECTRIC COMPANY. )

**DIRECT TESTIMONY**

**OF**

**ADAM H. GATEWOOD**

**ON BEHALF OF**

**THE KANSAS CORPORATION COMMISSION**

**OF THE STATE OF KANSAS**

1    **Q     Please state your name and business address.**

2    A     Adam H. Gatewood, 1500 Arrowhead Road, Topeka, Kansas 66604.

3    **Q     Who is your employer and what is your title?**

4    A     I am Managing Financial Analyst for the Kansas Corporation Commission  
5           (Commission).

6    **Q     What is your educational and professional background?**

7    A     I graduated from Washburn University with a B.A. in Economics in 1987 and a  
8           Masters of Business Administration in 1996. I have filed testimony on cost of  
9           capital, capital structure, and related issues before the Commission in more than  
10          95 proceedings and before the Federal Energy Regulatory Commission.

11   **Q     What is the purpose of your testimony?**

12   A     My testimony discusses Staff's handling of the interest expense and principal  
13          payments that Southern Pioneer incurred with the \$9,686,403<sup>1</sup> premium it paid  
14          to Rural Utilities Services (RUS) to buyout of a loan agreement.

15   **Q     How is the buyout premium handled in Staff's revenue requirement?**

16   A     The buyout-premium was rolled into the financing Southern Pioneer obtained  
17          from CoBank. Staff's revenue requirement for Southern Pioneer includes all of

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<sup>1</sup> Response to KCC #87

1 its interest expense; including the interest expense associated with the buyout  
2 premium.

3 **Q Please explain why Staff believes it is necessary to include all of Southern**  
4 **Pioneer's debt and interest expense.**

5 A That is because there are no investors to absorb the interest expenses that are  
6 disallowed, as would be the case when expenses are excluded from an investor-  
7 owned utility's revenue requirement. In the case of an investor-owned utility  
8 disallowing an expense results in a lower profit margin for its equity investors  
9 (stockholders); however, with a cooperative structure (or in this instance a  
10 corporation owned by a cooperative), the ratepayers are providing the equity  
11 capital, thus that shift cannot occur. As discussed by Staff witness Laura  
12 Bowman, Staff is not including the non-cash expense associated with  
13 amortizing the acquisition premium Southern Pioneer incurred when it acquired  
14 the Aquila properties. Staff is including recovery of the cash expenses (or  
15 interest expense) associated with financing the acquisition premium. Staff's  
16 treatment of the RUS debt buyout premium is consistent with its treatment of  
17 the acquisition expense.

18 **Q Please discuss the debt covenants directly affected by disallowing any**  
19 **interest expense.**

1 A A disallowance of a cash expense, such as an interest expense, would directly  
2 affect Southern Pioneer's ability to meet its Debt Service Coverage (DSC)  
3 requirements. CoBank calculates DSC using the following formula:<sup>2</sup>

4 
$$DSC = \frac{\text{Net Inc.} + \text{Depr.} + \text{Amort.} + \text{Interest Exp.} - (\text{noncash patronage} + \text{noncash income from joint ventures})}{\text{Interest Exp.} + \text{Principal Payments}}$$

5 Disallowing a portion of Southern Pioneer's interest costs from the revenue  
6 requirement would lower its net income in the numerator, while the actual  
7 interest payments made by Southern Pioneer would remain the same; the result  
8 is a lower DSC number.

9 **Q How do the debt covenants affect Staff's revenue requirement calculation**  
10 **for Southern Pioneer?**

11 A Staff's revenue requirement was developed using financial schedules based on  
12 meeting a DSC ratio of 2.00. Staff is recommending the Commission reject the  
13 phase in option as presented by Southern Pioneer, without the phase-in of the  
14 rate increase CoBank will require Southern Pioneer to meet a minimum DSC of  
15 1.35 each quarter for the twelve-month period ending with that quarter.<sup>3</sup> Staff  
16 witness Laura Bowman prepared and sponsors the revenue requirement  
17 schedules.

18 **Q Has Southern Pioneer maintained compliance with its loan covenants?**

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<sup>2</sup> Direct Testimony of Richard J. Macke, p.19 & Response to CURB DR #11; Mortgage Agreement p.6.

<sup>3</sup> Direct Testimony of Richard J. Macke, p.20 & Response to CURB DR #11; Loan Contract, Section 5.4

1 A Yes, it appears that it has been in compliance with the coverage ratio.

DSC	
2008	1.48
2009	1.76
2010	2.23
CURB, DR #62	

2 Q Are there other consequences to disallowing a portion of its interest  
3 payments from the revenue requirement?

4 A Yes, Southern Pioneer could continue to have difficulty building up its equity  
5 balance. From a policy perspective, Staff believes it is important cooperatives  
6 not be financed exclusively or almost exclusively by debt, even though  
7 cooperatives generally have access to reasonably priced loans. Equity in their  
8 capital structure lessens the cooperatives' reliance on lenders and reduces  
9 volatility in their financial performance. Disallowing a portion of Southern  
10 Pioneer's interest expense would reduce its net margins (net income) added to  
11 the equity balance each year. Its agreement with CoBank also requires it to  
12 achieve certain benchmarks, improving its equity position over the next six  
13 years.<sup>4</sup> Specifically, the agreement calls for Southern Pioneer to increase its  
14 "equity to total assets" ratio to 11% by the end of 2019. At the end of 2010,  
15 Southern Pioneer's ratio was less than one-percent, but it is positive for the first  
16 time since Southern Pioneer's inception in 2007.

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<sup>4</sup> Direct Testimony of Richard J. Macke, p.20.

1 Q Does this conclude your testimony?

2 A Yes.

## CERTIFICATE OF SERVICE

12-MKEE-380-RTS

I, the undersigned, hereby certify that a true and correct copy of the above and foregoing Direct Testimony was served via electronic service this 20th day of April, 2012, to the following:

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