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Kansas Corporation Commission
/S/ Patrice Petersen-Klein

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BEFORE THE KANSAS CORPORATION COMMISSION
OF THE STATE OF KANSAS

Application for Revised Rates, Tariffs, and Rate Design Changes

of

Mid-Kansas Electric Company, LLC

Docket No. 12-MKEE-380-RTS

December 19, 2011

PREFILED DIRECT TESTIMONY
STEPHEN J. EPPERSON
PRESIDENT AND CHIEF EXECUTIVE OFFICER
SOUTHERN PIONEER ELECTRIC COMPANY

ON BEHALF OF
<u>MID-KANSAS ELECTRIC COMPANY, LLC</u>

Q. Please state your name and business address.

A. My name is Stephen J. Epperson. My business address is 1850 W. Oklahoma, PO Box 430, Ulysses Kansas 67880-0430.

Q. What is your profession?

A. I am the President and Chief Executive Officer of Southern Pioneer Electric Company ("Southern Pioneer"), pursuant to the Services Agreement entered into between Pioneer Electric Cooperative, Inc. ("Pioneer") and Southern Pioneer on July 7, 2006. Our corporate office is located in Ulysses, Kansas, and our distribution-customer service offices are located in Liberal and Medicine Lodge, Kansas.

Q. Please describe the business activities of Southern Pioneer.

A. As a Mid-Kansas Electric Company, LLC ("Mid-Kansas") distribution member-system and owner, and pursuant to the July 2, 2007, Electric Customer Service Agreement approved by the Kansas Corporation Commission ("Commission" or "KCC") on December 21, 2007 in Docket No. 08-MKEE-099-MIS, Southern Pioneer provides retail and distribution service to approximately 17,200 Mid-Kansas retail consumers. Southern Pioneer also provides sub-transmission service to 34.5kV sub-transmission users.

Q. Please describe your responsibilities with Southern Pioneer.

A. The President and CEO ("CEO"), along with other executive officers and vice presidents, are appointed by the Board of Directors. As the CEO, I work directly for the Board of Directors and am responsible for assisting in establishing policy, implementing strategic programs, establishing rates and the overall operation of Southern Pioneer to ensure reliable service at a competitive cost, all while using generally acceptable industry business practices. I also work in close cooperation with Mid-Kansas to provide reliable service at reasonable rates for the Mid-Kansas customers that Southern Pioneer services under contract with Mid-Kansas.

Q. What is your educational background?

A. I graduated from Ozark Christian College, a cooperative program with Missouri Southern State University, in 1991 with a Bachelors Degree, which included double majors in Bible and Psychology. In 2002, I successfully completed the National Rural Electric Cooperatives' Management Internship Program through the University of Nebraska at Lincoln, Nebraska. In 2010, I received my Masters of Business Administration.

Q. What is your professional background?

A. I was appointed Southern Pioneer's CEO effective January 1, 2011. Prior to that date, I served as the President and CEO at McDonough Power Cooperative located in Macomb, Illinois from July 2006 to December 31, 2010. From August 2001 to July 2006, I served as the Senior Vice President of Northeast Rural Services, Inc., a subsidiary of Northeast Oklahoma Electric Cooperative. I have also served in other capacities, at both utilities and the private not-for-profit sectors as a business supervisor, consultant, business development director and counselor, etc.

Q. Have you previously presented testimony before the KCC?

A. No, I have not.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is four-fold. One, provide historical information on the formation of Southern Pioneer; two, affirm Southern Pioneer's business philosophy as it relates to the operation of the Mid-Kansas' Southern Pioneer division; three, provide testimony supporting implementation of Debt Service Coverage ("DSC") Ratemaking approach to be applied over a five year time period and its benefits to both the consumers and the utility; and four, discuss the negative impact of Pioneer Electric Cooperative, Inc. ("Pioneer"), our parent company, being required to provide loan guarantees in order for Southern Pioneer to borrow money for capital projects and general operating expenses in the future.

Q. Please provide historical information on the formation of Southern Pioneer.

A. In March of 2005, Aquila, Inc. announced its intentions to sell its Kansas electric assets. Upon Mid-Kansas and Aquila executing an Asset Purchase Agreement dated September 21, 2005, Southern Pioneer was created in November 2005 as a Kansas subsidiary corporation, wholly owned by sole shareholder Pioneer for the purpose of combining with five other Mid-Kansas members to acquire and serve the former Aquila service territory. After KCC approval of the Aquila and Mid-Kansas Joint Application in Docket No. 06-MKEE-524-ACQ ("524 Docket"), effective April 1, 2007, Southern Pioneer began to serve and independently operate a designated geographic portion of the certificated territory transferred from Aquila to Mid-Kansas as described earlier.

Q. Please describe Southern Pioneer's overall business philosophy in serving the Mid-Kansas' Southern Pioneer Division customers and service territory?

A. It is Southern Pioneer's mission to provide the Mid-Kansas customers the best possible service at the lowest possible price, while managing risk.

Q. Could you please be more specific in describing this philosophy?

A. In practice, Southern Pioneer attempts to strike a balance between providing reliable and outstanding customer service versus the costs or risks associated with failing to maintain the Mid-Kansas system to meet industry standards, so as to minimize the financial impact to the end-use consumer, the ratepayer. This endeavor includes, but is not limited to, continuing a community presence through local offices; systematic plant investment based on engineer-designed and Board-approved construction work plans; mitigating or managing the expenses and risks associated with providing and maintaining a capital intensive distribution and sub-transmission systems in accordance with prudent utility practices while achieving reasonable financial targets, such as meeting lender's loan covenants.

Q. Southern Pioneer is formed as a C-Corporation as opposed to a non-profit member-owned cooperative. Does this business structure negatively affect Southern Pioneer's business model to provide the Mid-Kansas customers the best possible service at the lowest possible price, while managing risk?

A. No, the chosen business structure does not negatively affect Mid-Kansas customers. As previously outlined in Southern Pioneer and KCC Staff testimony in the 524 Docket, and as ordered and as agreed to in the KCC approved Stipulation and Agreement in that same docket to which Southern Pioneer was a party and signatory, Southern Pioneer agreed to operate as any other similarly situated, not-for-profit taxable entity and not remit dividends to its sole shareholder Pioneer without KCC and lender approvals. Simply put, because of the age and condition of the acquired facilities and the lack of local customer service offices at the time of acquisition, rather than distribute excess revenues or margins, if any, to its sole shareholder Pioneer, Southern Pioneer pledged to reinvest these monies in Mid-Kansas' Southern Pioneer Division to create a local presence, enhance service and increase long-term reliability. Southern Pioneer has complied with this commitment over the past four years by opening and fully staffing two local customer service offices in Liberal and Medicine Lodge Kansas; increasing the overall level of staffing from the acquired twenty-four (24) Operations only positions to forty-six (46) full time equivalent positions necessary to support customer service, billing, metering, engineering and distribution related activities across a ten-county area. Since the acquisition date up through the end of the 2010 year, Southern Pioneer has invested $20,969,077 for capital related projects, and has spent $1,671,025 for maintenance, such as tree trimming and pole testing. These investments and expenditures have reduced outages and brought reliability to our customers. They are also some of the main drivers behind the need for a rate adjustment. There is no external or internal motive for Southern Pioneer to charge more than necessary to provide exceptional, reliable service at the lowest possible cost while achieving the prudent financial strength expected by financial institutions. Even though Southern Pioneer is not a cooperative, this practice is consistent with the cooperative principles under which Southern Pioneer operates, and would operate, even without the imposed requirements of the Stipulation and Agreement.

Q. We understand one of the goals in the Mid-Kansas filing of this rate application is to introduce a DSC Ratemaking Plan that includes implementation of an alternative regulatory framework termed "DSC Ratemaking" over a five-year timeframe. Is this understanding correct?

A. That is correct.

Q. In general terms, describe why implementing the proposed DSC Ratemaking Plan is believed beneficial to the Mid-Kansas' Southern Pioneer Division and its customers?

A. We believe there are many benefits – for the customers, regulators and Southern Pioneer – when considering DSC Ratemaking. It is common knowledge that the acquisition of the Aquila territory was one hundred percent debt financed. This fact, coupled with the known subsequent capital investments and the replacement expense associated therewith to date, resulted in negative to near zero equity for Southern Pioneer. The periodic adjustments to rates to meet predetermined DSC ratios over a five year timeframe, as opposed to traditional cost of service ratemaking, not only provides design and operational flexibility to begin building long-term financial stability, but also increases utility and regulatory efficiencies by consuming fewer resources and reducing regulatory approval lag, which ultimately and directly reduces operating costs associated with seeking prolonged regulatory approvals. Because required rate adjustments can be implemented more frequently in smaller increments, due to a pre-established and agreed-to formula and

KCC Staff review process, the DSC Ratemaking Plan naturally smoothes out the rate volatility for customers and provides the utility some degree of revenue predictability and certainty.

Q. Is this concept of using a financial ratio in ratemaking foreign to Kansas or the Commission?

A. No it is not. A variation is currently being utilized as a result of the Stipulation and Agreement adopted in the 524 Docket which ties rates to a Times Interest Earned Ratio ("TIER"). The Stipulation in the 524 Docket requires the Mid-Kansas Southern Pioneer division to file a Revenue Refund Plan with the Commission to reduce its TIER to 2.0 (the "Target") if it exceeds 2.2 (the "Ceiling"). What Southern Pioneer is proposing in this case is to substitute DSC for TIER, as defined by Southern Pioneer's lender, CoBank, and establish a "Floor," as described in more detail in Mr. Macke's prefiled testimony.

In fact, in the 524 Docket and on behalf of the KCC staff, consultant and former KCC staff member David N. Dittemore provided Direct Testimony titled "Conditions Applicable to Distribution Cooperatives, Including Southern Pioneer" stating, "Southern Pioneer will not object to Staff's use of TIER or DSC ratios in the determination of any subsequent Southern Pioneer revenue requirement. The intent of this provision is that Southern Pioneer's cost of capital determined for ratemaking purposes shall not be higher than what such calculation would produce if Southern Pioneer were a member owned cooperative."[1] As part of the settlement process, Southern Pioneer along with Mid-Kansas filed rebuttal testimony accepting KCC Staff's recommendation.

Q. What are the benefits to the Commission, Southern Pioneer and its customers as a result of adopting the DSC Ratemaking Plan as proposed by Southern Pioneer in this docket?

A. If approved, Southern Pioneer believes Mid-Kansas' DSC Ratemaking Plan for the Southern Pioneer Division will align Southern Pioneer's financial and business goals, while at the same time lowering costs and insulating customers from more abrupt and substantial rate increases resulting from traditional cost of service ratemaking based on historical information. Further, Mid-Kansas and Southern Pioneer will remain accountable to its customers served by Southern Pioneer for how it spends their money to balance the goals of 1) providing safe and reliable power, 2) achieving financial stability and 3) charging fair and reasonable rates.

Q. What if the Commission does not accept the DSC Ratemaking Plan for the Southern Pioneer division?

A. Should the Commission not allow the incremental DSC Ratemaking Plan, the Mid-Kansas Southern Pioneer Division rates will need to be increased to the full DSC level of 2.0 in order to achieve the revenue requirements identified in the cost to serve study, as presented in Mr. Macke's testimony.

Q. Please clarify why in the proposed DSC Ratemaking Plan, one can initially accept a lower DSC target that escalates over the life of the plan, but under the traditional Cost of Service methodology, a higher level is justified.

[1] Prefiled Testimony of David Dittemore, filed November 22, 2006, p. 9, para. 5.

A. As explained previously, implementing DSC Ratemaking over the five-year time period based on a floor, target and ceiling financial ratio that is adjusted "annually or as necessary" pursuant to an agreed-to formula and regulatory review process, creates predictable financial certainty for the utility and ensures the lender that the borrower is capable of meeting its current and future financial obligations. The key component here that is not present in traditional cost of service ratemaking is the annual review and adjustment frequency, whether it is a decrease or increase. These incremental annual adjustments, if necessary, eliminate the need to set or seek a larger initial DSC target than required to meet short-term obligations.

Under the traditional cost of service methodology, the utility's ability to timely recover its cost to serve is delayed because 1) it is done on a historical look back and 2) it is tempered by the time it takes for the company to examine the test year data, normalize and make necessary adjustments for measurable or material changes and then prepare and file the formal application. At that point, rate implementation is further delayed for up to 240-days while the Commission's standard rate case procedural schedule is followed. During this period, the utility is exposed to normal cost increases that may not be recovered through existing rates, and this lag not only adds future rate pressure, but also causes the utility to set a higher DSC target now in order to have the necessary revenues in the future until such time it can file a new application seeking additional rate recovery.

Q. As you referenced in the purpose of your testimony, you indicated that Pioneer could be negatively impacted by lenders requiring that Pioneer provide loan repayment

guarantees on behalf of and in order for Southern Pioneer to borrow money. Please explain how this requirement negatively affects Pioneer, when this guarantee will no longer be required and how the requested rate adjustment affects the guaranty?

A. As outlined previously, the acquisition of the Aquila assets in April 2007 were one hundred percent debt financed in that Southern Pioneer did not pay any of its own money. Because of Southern Pioneer's commitment to provide reliable service and replace aging infrastructure, and pursuant to the Stipulation and Agreement that the retail rates in effect at the time of acquisition could not be increased before March 2009, Southern made application and borrowed loan funds from both RUS and CoBank. Due to the near zero equity level starting out, exacerbated by the Southern Pioneer Division receiving only a ten percent increase in the first Mid-Kansas rate case[2] when it had requested a sixteen percent increase, both lenders required as a condition of lending to Southern Pioneer that Pioneer provide a continuing loan repayment guarantee.

Q. How could this requirement negatively affect Pioneer?

A. As part of the lending process and prior to loaning funds, lenders closely examine the financial profile of each borrower (amount of individual and consolidated debt and the ability in which to repay) and any of its subsidiaries, and then price the credit based on risk. In Pioneer's case, Southern's low to negative equity, coupled with the amount of debt of roughly $90 million guaranteed, caused lenders to scrutinize Pioneer's ability to service the additional debt as well as its own obligations. These guarantees are disclosed as part of Pioneer's annual audit in the form of a consolidated financial report and footnoted within the report.

[2] Docket No. 09-MKEE-969-RTS.

Q. When does this loan repayment guarantee expire?

A. Pursuant to the executed loan agreements and guarantees, the guaranty will remain in place until such time that Southern Pioneer's equity level reaches 15% of total assets, unless released beforehand by the lender.

Q. How will a rate adjustment affect the loan repayment guarantees?

A. Should the KCC approve the rate adjustment as outlined in the application and testimony, the additional revenues generated by the increase will systematically build equity to meet the equity specific targets identified by CoBank and as outlined in Mr. Macke's testimony.

Q. Does this conclude your prefiled Direct Testimony for the Mid-Kansas Southern Pioneer division rates?

A. Yes, it does.

VERIFICATION

STATE OF KANSAS)
) ss
COUNTY OF GRANT)

The undersigned, Stephen J. Epperson, upon oath first duly sworn, states that he is an officer of Southern Pioneer Electric Company, and that he has prepared the foregoing testimony, that he is familiar with the contents thereof, and that the statements contained therein are true and correct to the best of his knowledge and belief.

Stephen J. Epperson

Subscribed and sworn to before me this 19 day of December, 2011.

Judy J Parsons
Notary Public

JUDY J. PARSONS
MY COMMISSION EXPIRES
February 17, 2015

My appointment expires: Feb. 17, 2015