**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

In the Matter of the Application of Mid-Kansas Electric Company, LLC for an Order Approving the Conversion of Mid-Kansas Electric Company, LLC to Mid-Kansas Electric Company, Inc.	)))))	Docket No. 18-MKEE-014-MIS

NOTICE OF FILING OF STAFF REPORT AND RECOMMENDATION

The Staff of the State Corporation Commission of the State of Kansas (Staff and Commission, respectively) files the attached Report and Recommendation (R&R) and states as follows:

1. Staff hereby files the attached R&R recommending the Commission approve Mid-Kansas' Application to convert Mid-Kansas from an LLC to a taxable, nonprofit, non-stock membership corporation in order to regain FEMA eligibility. The Staff R&R evaluates the Application filed by Mid-Kansas Electric Company, LLC (Mid-Kansas) and concludes that conversion of Mid-Kansas is in the public interest and recommends the Commission approve the application as filed.

WHEREFORE Staff submits its Report and Recommendation for Commission review and consideration and for such other relief as the Commission deems just and proper.

Respectfully submitted,

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REPORT AND RECOMMENDATION
UTILITIES DIVISION

TO: Chairman Pat Apple
Commissioner Shari Feist Albrecht
Commissioner Jay Scott Emler

FROM: Chad Unrein, Senior Auditor
Justin Grady, Chief of Accounting and Financial Analysis
Jeff McClanahan, Director of Utilities

DATE: September 25, 2017

SUBJECT: Docket No. 18-MKEE-014-MIS—In the Matter of the Application of Mid-Kansas Electric Company, LLC for an Order Approving the Conversion of Mid-Kansas Electric Company, LLC to Mid-Kansas Electric Company, Inc.

EXECUTIVE SUMMARY:

On July 12, 2017, Mid-Kansas Electric Company, LLC (Mid-Kansas) filed an Application requesting Kansas Corporation Commission (KCC or Commission) approval to convert to a corporation from a limited liability company (LLC). The Application explains that Mid-Kansas is seeking to convert from an LLC to a nonprofit, non-stock membership corporation, the same business entity classification as Sunflower Electric Power Corporation (Sunflower). Mid-Kansas desires to convert its business entity classification in order to regain eligibility for Federal Energy Management Agency (FEMA) reimbursement in the event of a natural disaster.

In order to complete the conversion, Mid-Kansas is utilizing the provisions of the Business Entity Transaction Act, K.S.A. 17-78-401 to 17-78-406, which allows an entity to convert from an LLC to a corporation by completing an Agreement of Conversion. K.S.A 17-78-104b requires that Mid-seek approval from the KCC for this conversion. Once the conversion is complete, Mid-Kansas becomes a corporation which is the same entity without interruption as the previous LLC. In this way, the conversion is essentially like a corporate name change.

Because this transaction arguably requires approval under K.S.A. 66-131 and 66-136, Mid-Kansas addresses the Commission's Merger Standards where they are applicable for a transaction such as this conversion. Staff has reviewed the Application and recommends approval of Mid-Kansas' request to convert to a nonprofit, non-stock membership corporation, just like its affiliate, Sunflower. This will allow MKEC to regain eligibility for FEMA reimbursement in the event that a natural disaster causes damage to a significant amount of Mid-Kansas utility assets. The only potential risk of this conversion that Staff has identified is limited to the fact that nonprofit membership corporations face potential tax liabilities that can arise if the amount of non-member income earned in a particular year exceeds the tax deductions available to the entity by the Internal Revenue Service. Mid-Kansas witnesses address this potential risk and state that it is manageable and not likely a material concern, especially compared to the risk of being denied FEMA eligibility in the event of a significant natural disaster. Staff agrees and recommends the Commission approve Mid-Kansas' Application as filed.

BACKGROUND:

On July 12, 2017, Mid-Kansas filed an Application requesting approval to convert its business entity structure from an LLC to a nonprofit, non-stock membership corporation. This is the same business entity classification as Mid-Kansas' affiliate, Sunflower. Mid-Kansas seeks this conversion from an LLC to a nonprofit membership corporation in order to regain eligibility for FEMA reimbursement in the event that it experiences damage during a natural disaster.

The Application explains that FEMA makes financial assistance available to "private nonprofit organizations or institutions which own or operate a private nonprofit facility as defined in §205.221(e)." Private nonprofit organizations are entities that can demonstrate its nonprofit status in one of the following two ways:

1) By providing an IRS "ruling letter" granting tax exempt status under Section 501(c), (d), or (e) of the Internal Revenue Code, and is able to represent to FEMA that this letter is effective; or,
2) By providing "satisfactory evidence from the State that the nonrevenue producing organization or entity is a nonprofit one organized and doing business under state law."[1]

In the Application and Testimony, Mid-Kansas explains that it has historically been granted eligibility by FEMA for reimbursement of damages resulting from federally declared natural disasters. In April 2013 and again in July 2013, Mid-Kansas received almost $500,000 of public assistance as reimbursement for costs incurred in response to these natural disasters. However, in August 2015 and again in April 2017, Mid-Kansas was denied eligibility for FEMA reimbursement for damages it incurred because of natural disasters. The Application explains that Mid-Kansas believes it was denied FEMA reimbursement because the State of Kansas does not provide an acceptable form of certification that LLCs are organized as a not-for-profit. Since Mid-Kansas is an LLC and not a tax-exempt entity organized under Section 501 of the Internal Revenue Code, Mid-Kansas also could not demonstrate its nonprofit status by obtaining a ruling letter from the IRS. As a result, Mid-Kansas faced the prospect of being ineligible for public assistance in the event of a major natural disaster.

In order to regain FEMA eligibility, Mid-Kansas has decided to convert its business entity structure from an LLC to a nonprofit membership corporation. This will allow Mid-Kansas to be

[1] *See* §206.221(f) of FEMA's regulations and paragraph 9 of the Application.

organized the exact same as Sunflower, which has never been denied FEMA eligibility. In order to complete this conversion, Mid-Kansas is utilizing the provisions of the Business Entity Transaction Act, specifically, K.S.A. 17-78-401 to 17-78-406, which allows an entity to convert from an LLC to a corporation by completing an Agreement of Conversion. The Agreement of Conversion, revised Articles of Incorporation, and revised By Laws of Mid-Kansas are attached to the Application as Attachment A.

On September 14, 2017, the Western Kansas Industrial electrical Consumers Group (WKIEC) filed with the Commission a Petition to Intervene (Petition) in this Docket. In the Petition, WKIEC states that it supports the Application of Mid-Kansas for expeditious treatment and recommends to the Commission that the Application be approved.

ANALYSIS:

In support of the Application, Mid-Kansas filed the Direct Testimony of Stuart S. Lowry, President and Chief Executive Officer of Mid-Kansas, and H. Davis Rooney, Vice President and Chief Financial Officer of Mid-Kansas. Mid-Kansas also evaluates the conversion using the Commission's Merger Standards and concludes that the conversion from an LLC to a nonprofit membership corporation is in the public interest.

In Mr. Lowry's Direct Testimony, he discusses the fact that Mid-Kansas was denied FEMA eligibility for reimbursement for costs incurred as a result of a natural disaster in 2015 and again in early 2017. In explaining the rationale for Mid-Kansas to pursue conversion, Mr. Lowry explains that the appeal process at FEMA is a time intensive process that has no guarantee for success. Additionally, the Mid-Kansas members felt strongly that a permanent solution to FEMA ineligibility was needed. Mr. Lowry describes that each Mid-Kansas member has approved of the Conversion Agreement by appropriate corporate action. If the Commission approves the Application, Mid-Kansas will execute the Agreement of Conversion and file a Certificate of Conversion and new Articles of Incorporation with the Kansas Secretary of State's Office. At that point, Mid-Kansas will be officially converted to a nonprofit membership corporation instead of an LLC. Once converted, Mid-Kansas will be the same entity without interruption as the LLC with all the same rights, privileges, assets, owners, obligations, powers, and purposes as a corporation that it had as an LLC.

Because the Business Entity Transactions Act requires the Commission approve Mid-Kansas' conversion in accordance with K.S.A. 66-136 (one of the statutes that requires that mergers and acquisitions be approved by the Commission), Mr. Lowry uses the Commission's Merger Standards to support his position that the conversion is in the public interest. While Mr. Lowry recognizes that the conversion is not an acquisition or a merger, he indicates that the Merger Standards are instructive for determining whether the conversion is in the public interest. The Commissions' Merger Standards, as recently affirmed in Docket No. 16-KCPE-593-ACQ, are as follows:

(a) The effect of the transaction on consumers, including:

(i) the effect of the proposed transaction on the financial condition of the newly created entity as compared to the financial condition of the stand-alone entities if the transaction did not occur;

(ii) reasonableness of the purchase price, including whether the purchase price was reasonable in light of the savings that can be demonstrated from the merger and whether the purchase price is within a reasonable range;

(iii) whether ratepayer benefits resulting from the transaction can be quantified;

(iv) whether there are operational synergies that justify payment of a premium in excess of book value; and

(v) the effect of the proposed transaction on the existing competition.

(b) The effect of the transaction on the environment.

(c) Whether the proposed transaction will be beneficial on an overall basis to state and local economies and to communities in the area served by the resulting public utility operations in the state. Whether the proposed transaction will likely create labor dislocations that may be particularly harmful to local communities, or the state generally, and whether measures can be taken to mitigate the harm.

(d) Whether the proposed transaction will preserve the jurisdiction of the KCC and the capacity of the KCC to effectively regulate and audit public utility operations in the state.

(e) The effect of the transaction on affected public utility shareholders.

(f) Whether the transaction maximizes the use of Kansas energy resources.

(g) Whether the transaction will reduce the possibility of economic waste.

(h) What impact, if any, the transaction has on the public safety.

Mr. Lowry begins his evaluation of the Merger Standards on page 8 of his Direct Testimony. The conversion will technically have no immediate impact on the financial condition of the converted entity as there is no change in the assets, liabilities or equity position of Mid-Kansas. However, ensuring that Mid-Kansas regains eligibility for FEMA assistance in the event of a natural disaster will strengthen the overall financial position of Mid-Kansas because it will not be as exposed to the financial risks of natural disasters. This translates into a direct quantifiable benefit to ratepayers, depending on the size and intensity of the natural disaster. For example, Mr. Lowry reports that the damage to Sunflower's facilities in the recent April 30, 2017, ice storm exceeded $8 million.

With regard to standard (a)(v), Mr. Lowry testifies that the effect on competition of the conversion will be positive because it will allow Mid-Kansas to keep costs low, and therefore, competitive in areas where there is competition, such as new transmission construction. Mr. Lowry continues his discussion of merger standard (b) by stating there will be no environmental impact due to the conversion. In his evaluation of merger standard (c), Mr. Lowry states that the conversion will have a positive effect on state and local economies and the communities served by Mid-Kansas members. In the event of the natural disaster, federal funds provided by FEMA lessen the cost impact to ratepayers by covering approximately 85% of the repair and replacement costs of damaged or destroyed facilities. With regard to merger standard (d), Mr. Lowry testifies that Mid-Kansas' conversion will have no impact on the Commission's jurisdiction, and Mid-Kansas will remain self-regulated pursuant to K.S.A. 66-104d after the conversion.

In his analysis of merger standard (e), Mr. Lowry states that there will be no effect on the utilities shareholders since Mid-Kansas is not publicly held and, upon conversion, Mid-Kansas will become a nonprofit, non-stock membership corporation with no public or private shareholders. The current ownership interest of the six-member owners of the LLC will remain the same. The six Board of Directors will serve as the initial Board of Directors of the corporation until the first annual meeting at which the Board of will be expanded to 12 directors, two from each member.

Concerning merger standard (f), Mr. Lowry states the Mid-Kansas conversion will have no effect on the use of Kansas energy resources. With respect to merger standard (g), Mr. Lowry testifies the conversion should reduce economic waste to Mid-Kansas ratepayers by taking advantage of public funds from FEMA to repair and replace damaged facilities in the event a natural disaster occurs in the Mid-Kansas service territory. In reference to merger standard (h), Mr. Lowry states there should be no impact to public safety as result of the conversion.

Mr. Lowry concludes his analysis by stating the Mid-Kansas conversion from a LLC to a nonprofit, non-stock membership corporation is in the public interest and meets the standards the Commission considers for approval. By approving the conversion, Mid-Kansas would eliminate the concern of FEMA eligibility and gain access to public assistance funds that could lessen ratepayer impact of natural disasters without affecting customers.

As discussed above, Mid-Kansas also filed the testimony of Mr. Davis Rooney in support of the Application. Mr. Rooney discusses the actions that the member-owners of Mid-Kansas have taken to strengthen its argument for public assistance with FEMA in the event a natural disaster occurs prior to the Commission's approval of the conversion. Mr. Rooney testifies that the member-owners amended the Mid-Kansas Operating Agreement to provide for and to operate in accordance with cooperative principles, which requires the adoption of democratic voting with each member receiving one-vote and provides for allocation of patronage to the member-owners. Additionally, Mid-Kansas elected to become a taxable entity by changing its IRS taxable status from a partnership to a corporation. By making these modifications, Mid-Kansas adopts a business structure similar to Sunflower and is in a better position to assert its eligibility for FEMA funds if a loss were to occur before Commission approval. Upon approval of the Application, Mid-Kansas will complete the process of converting to a taxable, nonprofit, non-stock membership corporation in accordance with the Kansas Business Entity Transaction Act

Mr. Rooney continues his testimony discussing the financial and accounting implications that the conversion will have on membership equity, patronage, taxes, income and expenses, loan obligations, and potential rate impact. With regard to membership equity, Mr. Rooney states each membership share will remain the same as prior to the conversion; however, generally accepted accounting principles (GAAP) may require the member's capital account to be characterized as additional paid in capital. Similar to Sunflower, the conversion will require member earnings to be allocated on a patronage basis as set forth in the proposed bylaws attached to the Conversion Agreement. In explaining the tax implications of the Mid-Kansas conversion, Mr. Rooney states that prior to electing to be taxed as a corporation, Mid-Kansas had no income tax expense or liabilities. After electing to be taxed as a corporation, income tax liabilities are reflected at the Mid-Kansas corporate level, instead of at the member level. Mid-Kansas as a taxable entity will receive a patronage tax deduction to substantially reduce or eliminate income taxes on member related income; however, non-member income will be taxable to the extent non-member income exceeds allocated tax deductions.

In accordance with GAAP, Mid-Kansas is required to establish accumulated deferred income tax (ADIT) liabilities and assets. As for the accounting of income and expenses, Mr. Rooney states that to his knowledge there will not be any changes in accounting or amounts of Mid-Kansas' income or expenses beyond one-time expenses incurred for consulting fees, document name changes, filing fees. Concerning loans or borrowing obligations, Mr. Rooney testifies Mid-Kansas will remain obligated for the same amounts and subject to the same financial and non-financial covenants and the trust indenture obligations. In evaluation of the rate impact, Mr. Rooney emphasizes that Mid-Kansas's current rates, charges, classifications or schedule of charges, and any rule or regulation pertaining to the service of rates will remain the same after its conversion to a taxable nonprofit corporation. However, Mid-Kansas expects the conversion will have a favorable impact on rates since FEMA eligibility will reduce the facility maintenance and replacement cost in the event of a natural disaster.

As part of Staff's analysis, Staff issued discovery pertaining to the Mid-Kansas & Sunflower Articles of Incorporation and Bylaws; the Mid-Kansas Board of Directors Minutes and Presentations involving the conversion; and the Mid-Kansas member-owner approval process. Staff received copies of each Member Resolution passed by the member-owner's Board of Directors supporting the Mid-Kansas conversion from an LLC to a taxable, nonprofit, non-stock membership corporation. Staff also requested Mid-Kansas provide documentation supporting Mid-Kansas's conclusion that the conversion would be non-taxable. Mid-Kansas stated the transaction would be treated as a tax-free contribution to capital under Section 351 of the Internal Revenue Code. Upon the Mid-Kansas Board of Directors approving the decision to become a taxable entity, Mid-Kansas filed a FORM 8832 with the IRS to effectuate the desired conversion to a taxable corporation on May 25, 2017. The IRS provided notice of its approval to Mid-Kansas in a letter dated July 10, 2017.

Based on Staff's review of the Mid-Kansas Application, the Testimony of Mr. Lowry and Mr. Rooney, and Mid-Kansas' responses to Staff's discovery, Staff recommends the Commission approve the conversion to a taxable, nonprofit, non-stock membership corporation sought by Mid-Kansas. Mr. Lowry's testimony details Mid-Kansas' desire to ensure that it will be able to provide the necessary documentation to FEMA to regain eligibility for reimbursement of losses from a natural disaster. Without access to FEMA funds, Mid-Kansas ratepayers would fund the cost to repair destroyed or damaged facilities in the event of a storm. Mid-Kansas uses the

Commission's Merger Standards to establish that the conversion promotes the public interest in accordance with K.S.A. 66-136.

Mr. Rooney details the financial and accounting implication of the conversion of Mid-Kansas from an LLC to a nonprofit membership corporation. Mr. Rooney concludes that the conversion is a non-taxable event with limited effect on Mid-Kansas financial statements. Mr. Rooney further details the tax implications as a result of Mid-Kansas electing to become a taxable corporation and concludes the change will have a negligible impact on future tax liabilities due to patronage tax deductions. Since Mid-Kansas' corporate structure will be similar to Sunflower, Mr. Rooney points to Sunflower's history of NOL tax assets exceeding ADIT liabilities as additional support. Beyond one-time expenses, Mid-Kansas' current rates, charges, classifications or schedule of charges, and any rule or regulation pertaining to the service of rates will remain the same after its conversion to a taxable nonprofit corporation. Mr. Rooney concludes that the effects of the conversion will have a favorable impact on rates, since FEMA eligibility will reduce the ratepayer's impact of repair and replacement costs in the event of a disaster.

Staff concludes the conversion of Mid-Kansas to a taxable nonprofit corporation is in the public interest. Staff recommends the Commission approve Mid-Kansas Application for the conversion in order for Mid-Kansas to regain FEMA eligibility.

RECOMMENDATION:

Staff recommends the Commission approve Mid-Kansas' Application to convert Mid-Kansas from an LLC to a taxable, nonprofit, non-stock membership corporation in order to regain FEMA eligibility.

CERTIFICATE OF SERVICE

18-MKEE-014-MIS

I, the undersigned, certify that a true and correct copy of the above and foregoing Notice of Filing of Staff Report and Recommendation was served via electronic service this 27th day of September, 2017, to the following:

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