

STATE CORPORATION COMMISSION

NOV 02 2007

BEFORE THE

 Docket
Room

KANSAS CORPORATION COMMISSION

PREPARED DIRECT TESTIMONY OF

EARNEST A. LEHMAN

ON BEHALF OF

MIDWEST ENERGY, INC.

DIRECT TESTIMONY OF EARNEST A. LEHMAN

1 **Q: Please state your name, position and business qualifications.**

2 A: My name is Earnest A. Lehman, President and General Manager of Midwest Energy,
3 Inc. (Midwest Energy). I have been employed by Midwest Energy since 2003, first as
4 Chief Operating Officer, and since the beginning of 2004 as President and General
5 Manager. I have been a regulator or employee of natural gas and electric utilities since
6 1976. I worked for more than 18 years in regulatory, corporate development and
7 marketing management positions with the company now known as Westar and one of
8 its predecessors, followed by several years running an energy services
9 division/subsidiary of El Paso Electric Company in Texas. My earliest regulatory
10 experience was gained as an Economist at the Civil Aeronautics Board and the Federal
11 Energy Regulatory Commission in Washington, DC. I have a B.A. in Economics with
12 Distinction from the University of Wisconsin-Madison and an MBA in Finance and
13 Analysis from The George Washington University. I testified before the Commission
14 many times during my years with Westar and Kansas Gas and Electric Company. This
15 is my second appearance on behalf of Midwest Energy.

16 **Q: What is the purpose of your testimony?**

17 A: I will provide an overview of Midwest Energy's application, the reasons for the
18 increases, and the impact of this filing on our customer-owners. I conclude my
19 testimony by explaining how the ownership of Midwest Energy by its customers has
20 driven and is reflected in this filing to increase their electric rates.

21 **Q: What is the magnitude of the revenue increase proposed by Midwest Energy?**

1 A: Based on a pro forma test year ending June 30, 2007 and including the complete
2 integration of all nine units of the Goodman Energy Center (GMEC), Midwest Energy
3 proposes to increase base rate revenues collected from M System customers by \$6.4
4 million, an approximate 8.4% increase. As detailed in the testimony of Midwest
5 Energy witnesses Tom Meis (Chief Financial Officer) and Michael Volker (Director
6 Regulatory and Energy Services), it is necessary that Midwest Energy file the case
7 under the assumption that the rate increase for the first six units of the GMEC would
8 be applied to M System customers effective on July 1, 2008 and the remaining increase
9 be applied to M System customers effective on or about September 1, 2008. The
10 revenue requirement is detailed and supported by the testimony of Tom Meis, Midwest
11 Energy's Chief Financial Officer, with support for the cost of member-provided equity
12 given by the testimony of William K. Edwards of the National Rural Utilities
13 Cooperative Finance Corporation (CFC).

14 **Q: What is the total revenue requirement supported by Mr. Meis?**

15 A: \$107,245,422.

16 **Q: Including the full proposed increase, how much revenue will Midwest Energy**
17 **collect?**

18 A: \$104,217,477.

19 **Q: What does the difference of \$3,027,945 represent?**

20 A: Except for minor rounding differences in rate design, this represents the revenue
21 shortfall from W System customers. It will remain un-recovered until higher W
22 System rates can be put into effect.

1 **Q: Why isn't Midwest Energy proposing to increase W System rates?**

2 A: Midwest Energy is not proposing any increase in W System rates while it awaits the
3 Commission's ruling in Docket No. 08-MDWE-180-ACT, the application for an
4 accounting order. Should the Commission adopt the recommendation of Staff and
5 Midwest Energy concerning our ability to request an increase in W System rates, we
6 would expect to amend or refile this application or file a supplemental application in
7 accordance with the Commission's ruling. It is our strong preference that rates be
8 increased just once and for all customers, effective September 1, 2008. However, that
9 is not what we propose in this Application.

10 **Q: What is the impact of the proposed increase on a typical residential customer**
11 **utility bill?**

12 A: Using the pro forma test year, the average bill for an M System Residential class
13 customer will increase by \$12.32 per month based on usage of 851 kWh. The rate
14 design and spread of the increase is detailed and supported by the testimony of
15 Michael Volker.

16 **Q: Who else is prefiling direct testimony with respect to this application?**

17 A: Gary Vicinus, Vice President of Pace Global Energy Services, LLC will describe our
18 Risk Integrated Resource Plan (RIRP) and the supporting role of wind energy. Gary
19 Groninger, Senior Project Manager with Burns & McDonnell, details the RFP process
20 that followed development of our RIRP. Mr. Groninger explains how Midwest
21 Energy came to build GMCC and how it fits into Midwest Energy's power supply
22 portfolio. Ted Kelly, a Principal with Burns & McDonnell, will describe the condition

1 of Midwest Energy's other generating units and their suitability for continued use.

2 William Dowling, Vice President of Energy Management and Supply, will testify to
3 the classification of transmission assets. Finally, H. Edwin Overcast, Director with
4 Black & Veatch Corporation, provides information and support for Midwest Energy's
5 proposed Transmission Service Charge Adjustment.

6 **Q: Why does Midwest Energy seek to raise electric rates?**

7 A: Midwest Energy is in the early stages of a large scale replacement of its electric
8 infrastructure. Most obviously, our power supply contracts are expiring. By June 1,
9 2008 only one of Midwest Energy's current long-term Purchase Power Agreements
10 will remain in effect. That agreement, for 125 MW of coal-fired capacity from Westar
11 Energy, will expire June 1, 2010. After a generation of increasing reliance on other
12 utilities, Midwest Energy now sees tangible and intangible benefits from providing at
13 least some of its own peaking energy needs. We are also making major investments in
14 our transmission system with years more work ahead. And although we are proud of
15 our reliability record, it is also increasingly evident that our distribution system is aging
16 to the point where significant maintenance and replacement is required. Two recent
17 winter storms (November 2005 and New Years weekend at the end of 2006) plus the
18 May 2007 Greensburg tornado (which entered Midwest Energy service territory
19 shortly after leveling the town) wreaked havoc with large portions of our system.
20 Even with the significant financial and technical assistance available through FEMA
21 and the Kansas Division of Emergency Management, these storms triggered significant
22 unplanned investments. Fortunately, Midwest Energy's electric customers have

1 benefited for many years from our ability to capture efficiencies and achieve economies
2 of scale. Since 1989, Midwest Energy's base electric rates have declined once
3 (\$420,000 in 2000) and increased once (\$600,000 in 2003), for a net impact of
4 \$180,000 per year. This is less than 0.2% of test year revenues under current rates.
5 Unfortunately, recent and near-term projected cost increases mean we can no longer
6 hold the line on electric rates. Even with continuing modest sales growth, expenses
7 are increasing faster.

8 **Q: How have Midwest Energy's construction projects contributed to this rate**
9 **request?**

10 A: Construction projects are the main driver for this rate request. GMEC is the single
11 largest component. While GMEC is a cost-effective addition to Midwest Energy's
12 generating resources, it is still costly when compared to our heavily depreciated, older
13 power plants. We recently upgraded the operating voltage on the transmission line
14 connecting Hays and Great Bend (technically the Knoll-Heizer line) from 115 kV to
15 230 kV at a cost of \$6.3 million. This project will improve reliability across much of
16 our service territory. Additionally, Midwest Energy has made large investments in
17 improving service to customers formerly served by Westar (the W System). Since
18 acquiring these properties in August 2003, Midwest Energy conservatively estimates it
19 has invested approximately \$6.7 million in new facilities. For examples, we have
20 replaced and upgraded a critical transmission transformer, replaced a 60 year-old relay
21 system, grounded 22 miles of 34.5 kV transmission and provided overhead shielding

1 on these lines. We constructed a new warehouse/garage and a new relay building. All
2 of these examples pertain only to Rice County.

3 **Q: How have material, equipment and labor costs contributed to this rate request?**

4 A. In general, costs of material and equipment have soared in the last several years,
5 particularly in the aftermath of Hurricanes Katrina and Rita in 2005. Single phase,
6 pole-mounted transformers have gone up 44% in cost since 2004. Distribution poles
7 cost 29% more than they did three years ago. Finally, wage and related benefit costs
8 have increased thanks to a growing shortage of employees in many of our skilled
9 professions and continued escalation in the cost of health care.

10 **Q: Other than building generation, is Midwest Energy embarking in any new**
11 **directions?**

12 A: Yes, it is. Midwest Energy recently completed an Energy Efficiency Potential Study.
13 New programs are being designed consistent with the greatest areas of potential. Also
14 consider the launch, with our thanks for Commission support, of the How\$martSM
15 program and expanded efficiency efforts, covered in some detail by Mr. Volker's
16 testimony. This important new program and additional programs being developed in
17 concert with our older established energy efficiency and conservation programs,
18 signals Midwest Energy's increasing emphasis on minimizing customer bills, and not
19 necessarily having the lowest rates. More subtly, customers will have more choices in
20 how and when they will choose to consume energy. Midwest Energy will further
21 engage its customers in efforts to limit costs, and to limit the impact of their energy
22 use on the environment. We often forget that the choices we make in the buildings

1 where we live and work can be as significant to the environment as how we control
2 emissions from power plants and what vehicles we drive.

3 **Q: How else will Midwest Energy demonstrate environmental stewardship?**

4 A: Throughout history we have focused on the direct environmental impact of the
5 materials and equipment installed in our system. We stabilized or removed asbestos.
6 We monitored and replaced transformers with PCB's. We worked to reduce oil spills.
7 We did many day-to-day things which we will continue doing. But the world is
8 changing, and we all are becoming more aware of the links between energy, the
9 environment and economics. One cannot make a choice in one of these three areas
10 without a significant effect on the other two. This is one reason why Midwest Energy
11 is increasing its use of wind energy, even when such energy may displace cheaper
12 fossil-fueled resources. This is also one reason why we chose to construct GMEC. It
13 is both an efficient and clean generating resource. And this is a key reason why we
14 support the construction of both the Holcomb 2 power plant (for which no costs are
15 included in this rate case) and efforts to minimize its environmental impact. In
16 addition to these changes in how we run our business, Midwest Energy will play a
17 greater role in providing environmental information to its customers and in helping
18 customers understand the costs of various environmental choices. Make no mistake,
19 our expertise lies in energy. We are not environmental experts. But we do recognize
20 our responsibility to consider the environmental effects of the energy decisions we
21 make.

1 **Q: Why is the ownership of Midwest Energy by its customers an important factor**
2 **in this proceeding?**

3 A: Given my career working for investor-owned utilities and formerly as one of their
4 regulators, I am in a unique position to appreciate the irony of applying the standard
5 regulatory model to a customer-owned cooperative. Mr. Edwards addresses the
6 meaning and impact of customer-ownership generically in his testimony. Midwest
7 Energy respects the Commission's statutory and regulatory authority and the expertise
8 that Staff and interveners bring to the table. But in the end it is all the customers'
9 money and simply a matter of allocation between different rate classes, between
10 yesterday (retained member equity), today (rates/test year margins) and tomorrow
11 (deferred costs). Midwest Energy's management has no incentive to inflate or drive
12 up the costs of serving customers. They pay us. The Board they elect holds us
13 accountable for providing efficient and reliable service at a competitive cost. While
14 the Commission is the ultimate authority over this rate increase, the Board had to
15 authorize it first. The Board Resolution is included in Section 1 of the Application.

16 **Q: Why does Midwest Energy use the term "patronage capital" for equity?**

17 A: Because, as with other cooperatives, Midwest Energy's customers build their equity
18 ownership through their use of our services.

19 **Q: Why does Midwest Energy target a 20 year rotation of patronage capital?**

20 A: Unlike investors in publicly traded utilities, cooperative customers do not receive
21 dividends. They also do not hold fungible shares of stock that can be traded in a liquid
22 market. Midwest Energy's Board, like that of other Kansas cooperatives and

1 cooperatives across the country, believes customers should at some point get their
2 money back, and have it be replaced by margins earned more recently. This ensures
3 that customers currently receiving service are providing the capital for that service.
4 That's why we call it capital rotation. Our 20 year capital rotation cycle, with full
5 payment of capital credits to estates, reflects Midwest Energy's need to balance the
6 risks and lower costs of debt against the financial flexibility and higher cost of equity
7 financing for system replacements, improvements and additions.

8 **Q: Does this conclude your testimony?**

9 A: Yes.