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October 31, 2012

Lincoln City Council

Lincoln, Nebraska

Subject: Lincoln Electric System (LES) 2013 Operating and Capital Budget Appropriation Request

Chair Hornung and Members of the Lincoln City Council:

Enclosed for your review is the proposed 2013 LES Operating & Capital Budget and proposed Rate Schedules for rates effective January 1, 2013. The budget and accompanying rate increase were approved by the LES Administrative Board at a special meeting on October 30, 2012, and are recommended for your approval. We are seeking concurrent approval of both the budget and the rate increase.

We are proposing the following schedule for your consideration of the 2013 budget and rate increase:

- Monday, November 5 – Pre-Council Session at 1:30 pm
- Monday, November 5 – Introduction and First Reading
- Monday, November 19 – City Council Public Hearing
- Monday, December 3 – City Council action on the LES budget and rate increase

In addition and consistent with past practice, we have been and will continue to schedule individual briefings with members of the Council, as desired.

LES is recommending a 2013 Operating & Capital Budget that includes a system average increase in electric rates of 2.6% or approximately \$6.4 million effective January 1, 2013. Although the original 2013 budget projected a 3.8% adjustment, after significant review, staff and the Budget & Rates Committee implemented reductions to lower the adjustment to the proposed 2.6%.

Unlike prior years, there are no single significant drivers for this rate increase. While 2013 power costs increased compared to our current forecast for 2012, on a budget-to-budget comparison power costs are projected to be slightly lower in 2013, due in part to lower natural gas prices, the court vacation of the Cross-State Air Pollution Rule (CSAPR), and the fact that we will not have the overlapping generation maintenance outages (as we did in 2012).

Rather, the 2013 rate increase is due to a combination of numerous smaller drivers primarily in the Operating & Maintenance and Administrative & General expense categories. This \$5.0 million increase over the 2012 budget represents a small percentage (2%) of the 2013 operating budget. This increase is due to general growth in the business and maintenance expenses which were deferred in previous budget years to hold down rate increases. These costs can no longer be deferred for safety and reliability reasons. As is common in the electric industry, we are also experiencing increased regulatory compliance costs. Finally, we have a number of hardware and software upgrades that are necessary to maintain operating systems.

LES' bond ratings are a reflection of our fiscal strength to investors, financial institutions, rating agencies and others looking to assess the financial state of LES. As such, the 2013 budget achieves a 2.0 debt service coverage which necessitates a small increase in rates.

The State of LES

Lincoln Electric System serves its customer/owners by delivering economical, reliable and high-quality electric services, offering cost-effective programs to reduce energy consumption, and promoting environmentally friendly and sustainable solutions to meet customer energy needs. An indicator of our sound financial practices is our continued ability to pursue these business strategies in a dynamic business environment while offering services at rates that are among the lowest 10% of 106 major cities in the nation. Another is our consistently excellent financial ratings by Standard and Poor's and Fitch Ratings.

In 2012, we continued to focus our efforts on serving customers at the lowest possible cost while maintaining a strong emphasis on fiscal responsibility. We maximized opportunities to reduce expenses while continuing to reach significant service milestones. As we look to the future, we continue to seek opportunities to succeed in the midst of industry challenges as we strive to be the world's best energy company.

2012 Successes

The 2012 budget outlined a number of goals directed toward addressing reliability, sustainable energy and customer access and efficiency. The following identifies several accomplishments that have been completed thus far in 2012 in support of those goals:

- Planned and implemented projects, with significant customer/public involvement, to continue high system reliability
- Offered financial incentives to customers on equipment and services that make their homes and businesses more energy efficient
- Received affirmation of AA rating from financial rating agencies

- Achieved significant interest savings through the refunding of outstanding long-term revenue bonds
- Improvement in financial metrics
- Adopted and provided workshops on a formal ethics program
- Named 11th lowest in electric rates out of 106 major cities in the nation
- Conducted a new integrated resource plan to effectively serve growing customer needs

2013 Industry and LES Challenges

There are numerous challenges facing the electric utility industry, many driven by electric industry regulation and the associated compliance costs. LES continues to take a proactive approach to address these challenges to minimize the impact to our customers.

Some of these challenges include:

- Implementation of the Southwest Power Pool's (SPP) Regional Transmission Plan
- Increasing environmental and reliability regulatory compliance requirements
- Integrating renewable energy options
- Fuel cost and fuel transportation volatility
- An aging workforce

2013 Major Initiatives and Projects

On a daily basis, the LES team serves nearly 130,000 customers with 99.99% service reliability. This level of reliability rates in the top of our industry and requires continuous dedication to support the generation, transmission and distribution of annual energy sales in excess of 3 million megawatt-hours.

The 2013 budget provides the resources to support our ongoing commitment to low-cost, reliable energy as well as support for several major initiatives and projects. The following provides an outline of LES' long-term strategic priorities and the associated initiatives and projects which constitute a significant portion of our focus for 2013.

Outreach

- Implement a three-year communication plan to enhance internal and external communication
- Management of construction and operational activities for District Energy Corporation facilities, including the West Haymarket Development

- Redesign LES website to enhance customer service and communication

Employer of Choice

- Addition of 6 new FTEs to support regulatory compliance, succession planning and new market requirements
- Implement a succession planning pilot program
- Recruit, train and develop new staff in preparation for retirements of many long-term employees
- Refine compensation and benefits administration polices and processes

Customer Service

- Expand vegetation management practices to increase reliability
- Completion of the new Central Lincoln Reliability Project
- Begin work on the Southwest Reliability Project
- Maintain compliance with federal reliability standards
- Enhancements to customer billing system and contact center

Fiscal Responsibility

- Continued identification of enterprise risks and development of risk mitigation strategies
- Implementation of a Sustainable Energy Target (which was adopted in late 2011) which balances the cost and benefits for options related to demand-side reductions and sustainable generation resources
- Contribute \$2 million to the Rate Stabilization Fund supporting LES' goal of developing a fund available to mitigate identified risks
- Preparation for the Southwest Power Pool Integrated Marketplace implementation

Sustainability & Environmental Stewardship

- Construction of Bluff Road Landfill Gas Generation Project
- Integration of additional wind resources
- Continued conversion of paper records and processes to electronic

- Maintaining \$3 million in funding for the Sustainable Energy Program

2013 LES Staffing

Payroll and benefit expense comprise just 15 percent of the LES operating budget. For 2013, LES full-time employee levels are proposed to increase to 473, up six from the 2012 level. LES full-time staffing levels continue to be competitive with industry comparables on a customer's per employee basis. The additional positions in 2013 are primarily to support succession planning, regulatory compliance and increased market requirements.

2013 LES Budget Request

2013 Operating Budget

For 2013, LES is recommending a \$235.1 million Operating Budget to support its business plan consistent with LES' strategic mission and priorities. The 2013 Operating Budget reflects a 0.2% or about a \$585,000 increase over the approved 2012 Operating Budget.

2013 Capital Budget

For 2013, LES is recommending a \$70.9 million Capital Budget that represents a decrease of \$2.7 million or 3.7% from the 2012 budget. The capital budget includes completing the Central Lincoln Reliability Project, design and construction of a landfill gas generation plant and required regulatory compliance projects.

2013 Total Budget Authorization

Although the Operating Budget reflects planned operating expenses and is used to track budget progress in our monthly financial statement, for purposes of the City Council's approval, we include the Total Budget Authorization. The proposed 2013 Total Budget Authorization is \$326.2 million, a 0.1% decrease from the approved 2012 Total Budget Authorization. Operating Authorization is derived by subtracting depreciation from the Operating Budget and adding back debt service and Payments in Lieu of Tax (PILOT).

Summary

The proposed budget has been developed to maintain our public power commitment of providing reliable, low-cost electric service for our customers. The comparison of LES electric bills with bills from other utilities in the region reveals that LES bills continue to be among the lowest when comparing other utilities 2012 rates to our proposed 2013 rates. Please see the attached regional rate comparison as well as a schedule showing the rate class impact of the 2013 rate increase and the proposed retail rate schedules. As you review this material, please feel free to contact me, Laura, or a member of the Administrative Board with questions or comments.

Respectfully,



Kevin G. Wailes
Administrator & Chief Executive Officer

C: Laura Kapustka, Chief Financial Officer
 Doug Bantam, Chief Operating Officer
 Shelley Sahling-Zart, General Counsel
 Administrative Board

2013 Budget Authorization Request



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Proposed 2013 Total Budget Authorization

LES' proposed Total Budget Authorization for 2013 is \$326,244,000. The Operating Authorization is \$255.4 million which is increased \$2.3 million or 0.9% over the 2012 authorization. The Capital Authorization is \$70.9 million which is a decrease of \$2.7 million or 3.7% from the 2012 authorization. The following information summarizes the significant factors impacting LES' 2013 Proposed Budget and rate adjustment.



Proposed 2013 Total Budget Authorization

The 2013 budget projected a 3.8% rate adjustment. Through an internal review process, operating expenses were reduced by approximately \$1.0 million, which resulted in a required rate adjustment of 3.3%.

Through continued review of the proposed budget, in conjunction with the Budget and Rates Committee, the rate adjustment was further reduced by identification of additional expense reductions and incorporating a revised projection. The currently proposed rate adjustment is 2.6% or approximately \$6.4 million.

Unlike prior years, there are no single, significant drivers for this rate increase. While 2013 power costs increased compared to our current forecast for 2012, on a budget-to-budget comparison power costs are projected to be slightly lower in 2013; due in part to lower natural gas prices, the court vacation of the cross-State Air Pollution Rule (CSAPR), and the fact that we will not have the overlapping generation maintenance outages (as we did in 2012).

The table on the following page demonstrates the process to reach the proposed rate adjustment.

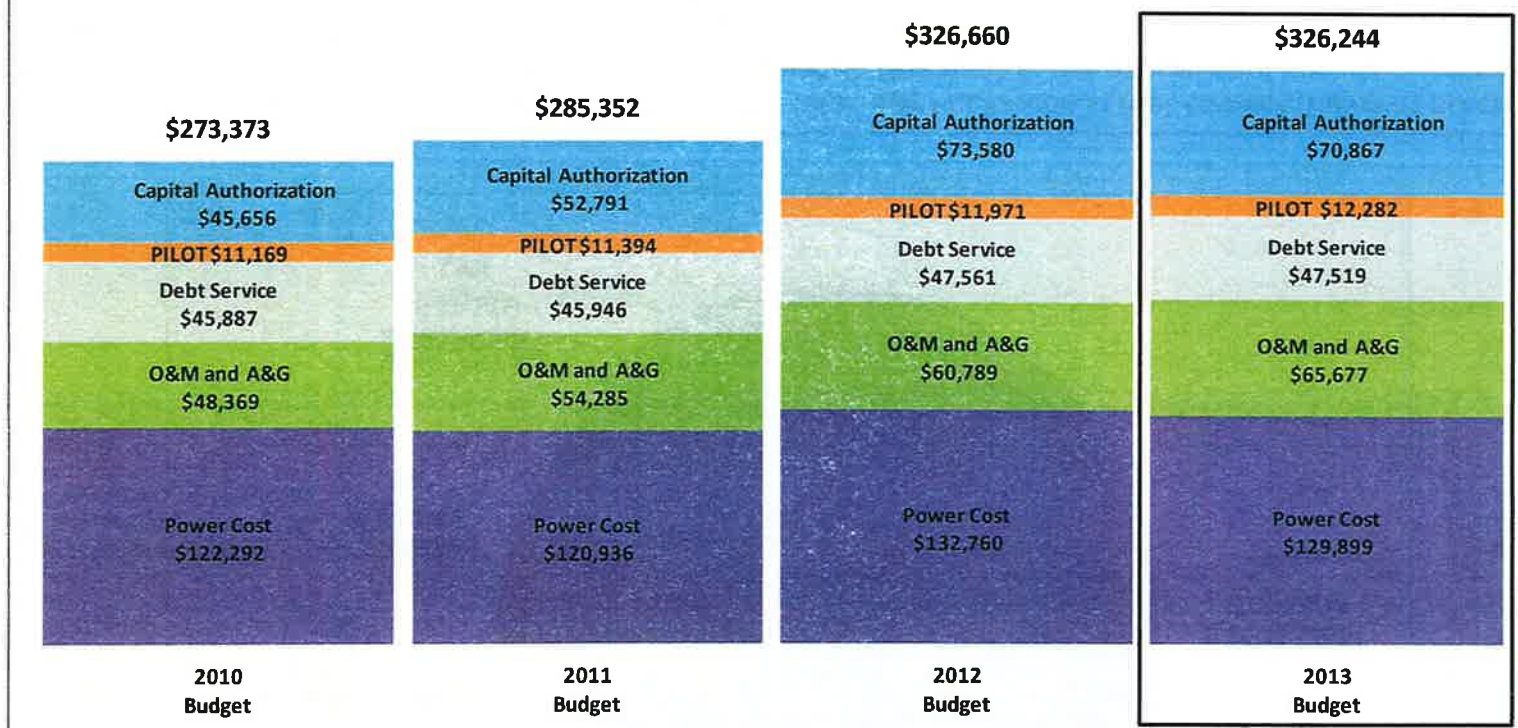


Rate Strategy – 2013 Rate Adjustment Progression

	Initial Case	Budget & Rates Committee Recommendation
Rate Stabilization Fund (millions)		
Deposit	\$ 2.0	\$ 2.0
SEP Funding (millions)	\$ 3.5	\$ 3.3
Rate Adjustment	3.8%	2.6%
Total Retail Revenue (millions)	\$ 256.4	\$ 254.5
Total O&M and A&G (millions)	\$ 67.2	\$ 65.7
Debt Service Coverage	2.00	2.00
Fixed Charge Coverage	1.37	1.37



2013 Total Authorization (in thousands)

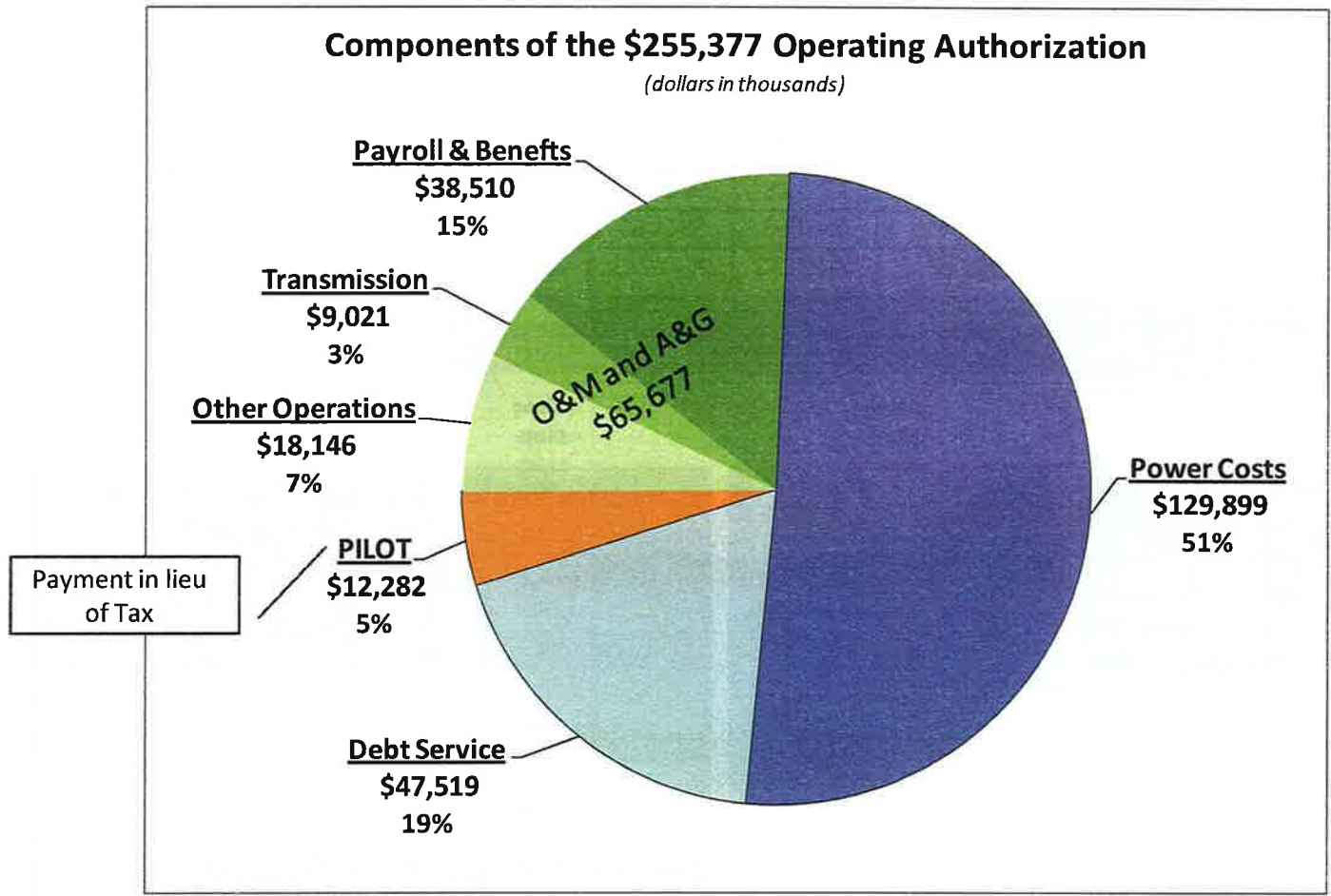


	2010 Budget	2011 Budget	2012 Budget	2013 Budget	2013 vs 2012 Var (\$)	2013 vs 2012 Var (%)
Power Cost	\$122,292	\$120,936	\$132,760	\$129,899	-\$2,860	-2.2%
O&M and A&G	\$48,369	\$54,285	\$60,789	\$65,677	\$4,888	8.0%
Debt Service	\$45,887	\$45,946	\$47,561	\$47,519	-\$42	-0.1%
PILOT	\$11,169	\$11,394	\$11,971	\$12,282	\$311	2.6%
Operating Authorization	\$227,717	\$232,561	\$253,080	\$255,377	\$2,296	0.9%
Capital Authorization	\$45,656	\$52,791	\$73,580	\$70,867	-\$2,713	-3.7%
Total Authorization	\$273,373	\$285,352	\$326,660	\$326,244	-\$416	-0.1%



Striving to be the world's best energy company.

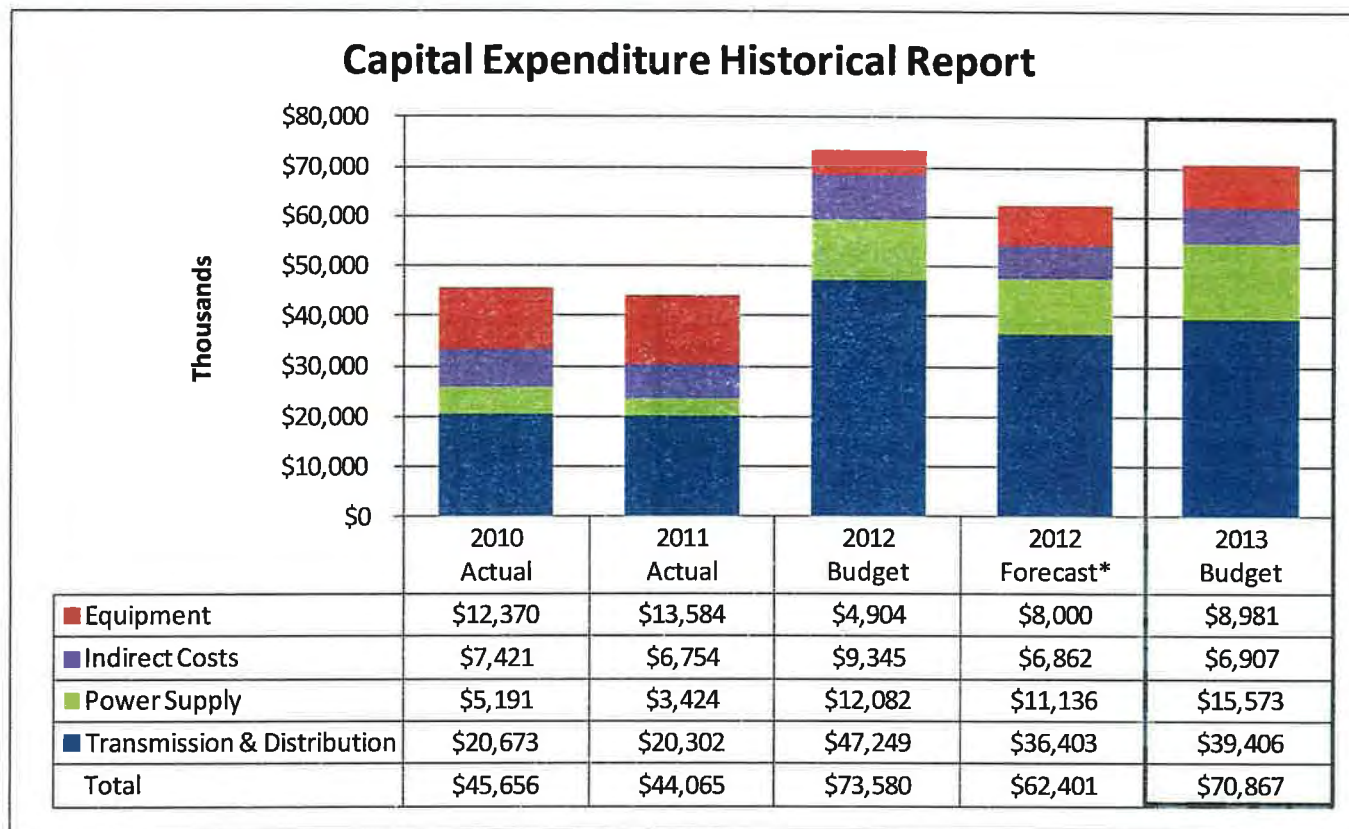
Proposed 2013 Operating Authorization



Because power costs constitute such a large percentage of the total, any fluctuation in fuel, transportation or purchased power from other utilities will have a significant impact on the budget. Nearly all of the annual debt service expense is also related to power cost as the debt was issued in support of generation and transmission facilities.



Proposed 2013 Capital Authorization



* Actuals through June 2012

2013 Capital Projects Funding Requirements:

- Central Lincoln Reliability Project (\$9.4 million)
- Landfill Gas (\$7.4 million)
- Laramie River Station capital investments (\$5.8 million)
- Upgrade of a 115kV line to Sheldon Station (\$5.6 million)
- Future LES Facilities (\$4.4 million)
- NERC required projects (\$2.5 million)

----- The table on the following page identifies significant projects included in the 2013 Capital Budget. -----



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2013 Rate Adjustment Drivers

	Rate drivers as compared to the 2012 Budget		Observations
	Impact (\$ in millions)	% Rate Increase	
O&M and A&G Adjustments:			
Information Technology	\$1.2	0.5%	The increase in O&M and A&G represents a small percentage (2%) of the 2013 operating budget. This increase is due to general growth in the business and maintenance expenses which were deferred in previous budget years to hold down rate increases. These items can no longer be deferred for safety and reliability reasons. An addition of 6 FTEs for regulatory compliance and succession planning purposes has been included. Increased regulatory compliance costs and expenses related to hardware and software upgrades are necessary to maintain operating systems.
Energy Delivery, NERC, Transmission	\$1.2	0.5%	
Payroll, Benefits & FTE additions	\$0.8	0.3%	
Other O&M and A&G	\$1.8	0.7%	
Total O&M and A&G Adjustments	\$5.0	2.0%	
Debt Service and Coverage Adjustments	\$1.9	0.8%	
Power Costs:			
Purchased Power	\$1.9	0.7%	On a budget-to-budget comparison, power costs are projected to be slightly lower in 2013, due to lower natural gas prices, the court vacation of the Cross-State Air Pollution Rule (CSAPR), and because there are not overlapping generation maintenance outages as occurred in 2012.
Production Power	(\$4.8)	-1.9%	
Total Power Costs	(\$2.9)	-1.2%	
Revenue Adjustments	\$2.4	1.0%	Changes in retail, wholesale and other revenue.
Proposed Rate Adjustment	\$6.4	2.6%	



2013 Operating & Capital Budget and Budget Request Summary

(Amounts in thousands)

Budget Request		
Operating Budget (including PILOT ¹)	247,377.7	
Less Depreciation & Amortization	(39,519.8)	
		\$207,857.9
Debt Service:		
2003 Bonds	4,073.2	
2005 Bonds	2,551.2	
2007A Bonds	4,549.2	
2007B Bonds	11,579.2	
2012 Bonds	24,057.9	
Commercial Paper	708.0	
		47,518.7
Capital Budget		70,867.4
Total Budget Request		<u>\$326,244.0</u>
Source of Funds		
Cash Receipts:		
Operating Revenue	\$290,946.3	
Interest & Other Income	250.5	
		\$291,196.8
Provided from current or borrowed funds		35,047.2
Total Source of Funds		<u>\$326,244.0</u>

¹Payment in Lieu of Tax (PILOT)



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