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Before the Kansas Corporation Commission

Direct Testimony

of

Robert B. Hevert

December 2018



**DIRECT TESTIMONY
OF
ROBERT B. HEVERT
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
KANSAS CORPORATION COMMISSION
DOCKET NO. 19-EPDE-__-RTS**

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	PURPOSE AND OVERVIEW OF TESTIMONY.....	2
III.	OVERVIEW OF THE COMPANY’S REQUEST AND NEED FOR REGULATORY RATE REFORM.....	3
IV.	RATEMAKING PRINCIPLES AND THE BENEFITS OF ALTERNATIVE RATEMAKING MECHANISMS	9
V.	ALTERNATIVE RATEMAKING TRENDS IN THE U.S.	12
VI.	THE COMPANY’S PROPOSED ALTERNATIVE RATEMAKING MECHANISMS .	14
	<i>Revenue Decoupling</i>	<i>14</i>
	<i>Cost Recovery Adjustment Mechanisms</i>	<i>19</i>
VII.	SUMMARY AND CONCLUSIONS	22

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GLOSSARY OF FREQUENTLY USED TERMS

TERM	DESCRIPTION
314-Docket	Docket No. 10-EPDE-314-RTS
AERR	Asbury Environmental and Riverton Rider
AMI	Advanced Metering Infrastructure
APUC	Algonquin Power & Utilities Corp.
Commission	Kansas Corporation Commission
Direct Testimony	Direct Testimony of Robert B. Hevert
DER	Distributed Energy Resources
ECA	Energy Cost Adjustment
Empire	The Empire District Electric Company
Liberty	Liberty Utilities Co.
MISO	Midwest Continent Independent System Operator
Moody's	Moody's Investor Service
RRA	Regulatory Research Associates
RTO	Regional Transmission Organization
S&P	Standard & Poor's
ScottMadden	ScottMadden, Inc.
SPP	Southwest Power Pool
TDC	Transmission Delivery Charge

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1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME, AFFILIATION, AND BUSINESS ADDRESS.**

3 A. My name is Robert B. Hevert. I am a Partner at ScottMadden, Inc. (“ScottMadden”).
4 My business address is 1900 West Park Drive, Suite 250, Westborough, MA 01581.

5 **Q. ON WHOSE BEHALF ARE YOU SUBMITTING THIS TESTIMONY?**

6 A. I am submitting this direct testimony (“Direct Testimony”) before the Kansas
7 Corporation Commission (“Commission”) on behalf of The Empire District Electric
8 Company (“Empire” or the “Company”), an indirect, wholly owned subsidiary of Liberty
9 Utilities Co. (“Liberty”), which is an indirect, wholly owned subsidiary of Algonquin
10 Power & Utilities Corp. (“APUC”).

11 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

12 A. I hold a Bachelor’s degree in Business and Economics from the University of Delaware,
13 and an MBA with a concentration in Finance from the University of Massachusetts. I
14 also hold the Chartered Financial Analyst designation.

1 **Q. PLEASE DESCRIBE YOUR EXPERIENCE IN THE ENERGY AND UTILITY**
2 **INDUSTRIES.**

3 A. I have worked in regulated industries for over thirty years, having served as an executive
4 and manager with consulting firms, a financial officer of a publicly traded natural gas
5 utility, and an analyst at a telecommunications utility. In my role as a consultant, I have
6 advised numerous energy and utility clients on a wide range of financial, regulatory, and
7 economic issues including corporate and asset-based transactions, asset and enterprise
8 valuation, transaction due diligence, regulatory strategy, dividend policy, and corporate
9 strategic matters. As an expert witness, I have provided testimony in more than 250
10 proceedings regarding various financial and regulatory matters before numerous state
11 utility regulatory agencies, U.S. Federal Court, the Federal Energy Regulatory
12 Commission, and the Alberta Utilities Commission. A summary of my professional and
13 educational background, including a list of my testimony in prior proceedings, is included
14 as Attachment A to my Direct Testimony.

15 **II. PURPOSE AND OVERVIEW OF TESTIMONY**

16 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?**

17 A. The purpose of my Direct Testimony is to provide an overview of regulatory ratemaking
18 reform policies generally, and to support the Company's specific request for certain new
19 ratemaking mechanisms. In particular, my Direct Testimony addresses Empire's
20 proposal¹ for specific alternative ratemaking mechanisms which, consistent with

¹ The Company's proposals are explained by Company witnesses Timothy S. Lyons and Aaron J. Doll.

1 fundamental regulatory objectives and ratemaking principles, are designed to better align
2 the interests of customers and the Company.

3 **Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?**

4 A. The remainder of this Testimony is organized as follows:

5 Section III – Provides an overview of the Company’s proposal in the general context
6 of regulatory reform;

7 Section IV – Discusses the benefits of alternative ratemaking mechanisms and their
8 consistency with ratemaking principles and objectives;

9 Section V – Discusses broad national trends in regulatory reform and alternative
10 ratemaking mechanisms;

11 Section VI – Discusses the Company’s proposed alternative rate structures; and

12 Section VII – Summarizes and concludes my testimony.

13 **III. OVERVIEW OF THE COMPANY’S REQUEST AND NEED FOR**
14 **REGULATORY RATE REFORM**

15 **Q. PLEASE PROVIDE A BRIEF SUMMARY OF THE COMPANY’S REQUEST IN**
16 **THIS PROCEEDING.**

17 A. As described in more detail by Company Witnesses Timothy S. Lyons and Aaron J. Doll,
18 the Company proposes three ratemaking alternatives to address persistent revenue
19 deficiencies. Specifically, the Company requests the approval of: (1) a revenue
20 decoupling mechanism (the “Revenue Stabilization Rider”); (2) a Capital Tracker Rider
21 mechanism to recover key investments associated with grid resiliency, generation
22 capacity, and other capital investments; and (3) a Transmission Delivery Charge (“TDC”)

1 to recover transmission-related costs associated with investment in the Bulk Electric
2 System.

3 **Q. PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING THE**
4 **COMPANY'S PROPOSALS, AND HOW THEY BENEFIT BOTH CUSTOMERS**
5 **AND INVESTORS.**

6 A. The Company's proposals are driven by several factors that reduce revenues and increase
7 operating costs just as cash flow is required to fund the capital investments needed to
8 provide safe and reliable service. Those factors – declining load, increasing operating
9 costs, and continuing capital investment requirements – have affected electric utilities
10 across the Country. Utilities and regulatory commissions have recognized that under
11 current conditions, traditional cost of service regulation is not likely to provide the timely
12 recovery of costs needed to ensure customers are served by financially sound utility
13 companies. They have addressed those concerns by implementing alternative ratemaking
14 mechanisms similar to those included in the Company's proposal.

15 Utility companies, regulatory commissions, and the financial community have
16 recognized that traditional cost recovery no longer adequately addresses the needs of
17 customers and investors, and that some form of regulatory reform is needed to protect the
18 common interests of multiple constituencies. As with the Company's proposal, the
19 mechanisms put in place at other utilities address the dilution in cash flow that inevitably
20 would diminish their financial profile, ultimately to the detriment of customers and
21 investors, and mitigate the need for increasingly frequent and costly rate proceedings.

1 **Q. WHAT HAS BEEN THE TRADITIONAL FRAMEWORK OF COST**
2 **RECOVERY FOR UTILITIES SUCH AS EMPIRE?**

3 A. Under traditional regulation, utilities are granted an exclusive service territory in
4 exchange for the obligation to provide service to customers within that territory, and to be
5 subject to rate regulation, including a regulated rate of return. In large measure, cost of
6 service regulation, which establishes the authorized level of revenue and returns, arises
7 from the “essential” nature of utility services, whose unit costs decrease with increasing
8 levels of output. Because of their declining cost structures, utility services in a given
9 market area are more efficiently provided by a single firm than by multiple firms.²
10 Although they may serve different market sectors (*e.g.*, electricity, natural gas, water,
11 waste water), utilities typically are capital-intensive enterprises whose investments are
12 long-lived, essentially irreversible, and represent high “sunk” costs.

13 Under traditional cost-of-service ratemaking, the process of setting just and
14 reasonable rates applies historical costs in a given “test year” to determine revenue
15 requirements, billing determinants, and customer rates for the rate-effective period. The
16 approved rates then are fixed until the next rate case. That is, historical costs are used to
17 set future rates, which results in a lag between the time funds are expended and rates are
18 set to recover those costs. Under the traditional ratemaking structure, if sales are higher
19 than anticipated, the utility’s profits will be higher (all else equal). The utility may retain
20 those profits between rate cases to fund additional capital and operating costs. However,
21 if sales are lower than anticipated, revenues (and profit) will be lower, and the utility may
22 not have sufficient earnings and cash flow to cover its fixed costs and invest in the capital

² Sometimes referred to as the principle of “cost subadditivity”.

1 necessary to provide safe and reliable service. Regulatory lag, therefore, is a significant
2 challenge for utilities whose costs are rising more rapidly than sales.

3 **Q. HOW DOES THE CURRENT ENVIRONMENT DIFFER FROM THE**
4 **SCENARIO IN WHICH TRADITIONAL COST OF SERVICE REGULATION**
5 **ENABLED UTILITIES TO MAINTAIN THEIR FINANCIAL STRENGTH AND**
6 **TO PROVIDE SAFE AND RELIABLE SERVICE?**

7 A Quite simply, sales volumes have declined even though the need to maintain service
8 reliability, to replace aging infrastructure, and to address public policy objectives have
9 continued, or even increased. For example, investments required to maintain reliability
10 do not generate incremental revenue through additional load growth. Unlike prior
11 periods when traditional cost of service regulation and load growth enabled the timely
12 return of and on incremental non-revenue producing investments, the current
13 environment does not.

14 As a result, utilities such as Empire cannot rely on load growth or increased
15 profitability generated through reduced operating and maintenance costs to fund their
16 infrastructure replacements, or to sustain their financial integrity. That condition presents
17 considerable financial challenges for utilities that, like Empire, have a continuing need to
18 invest significant capital in non-revenue producing infrastructure. That earnings pressure
19 becomes even more acute as the rate of capital expenditures accelerates.

20 Increasing capital investments, together with reduced sales, also have created a
21 circumstance in which each dollar of invested assets produces fewer dollars of revenue.
22 When that occurs, the ability to fund capital investments through growth-related revenue

1 increases will be limited. Absent other solutions, those investments must be funded
2 through more frequent and costly rate filings.

3 **Q. HAVE FINANCIAL PARTICIPANTS SUCH AS RATING AGENCIES**
4 **RECOGNIZED THE CONCERNS SUMMARIZED ABOVE?**

5 A. Yes, they have. Standard and Poor’s (“S&P”), for example, states that “[o]ne significant
6 aspect of regulatory risk that influences credit quality is the regulatory environment in the
7 jurisdictions where a utility operates.”³ S&P explains that:

8 ...[w]hen we evaluate U.S. utility regulatory environments, we
9 consider financial stability to be of substantial importance. Cash takes
10 precedence in credit analysis. A regulatory jurisdiction that recognizes
11 the significance of cash flow in its decision-making is one that will
12 appeal to creditors.⁴

13 Similarly, Moody’s Investor Service (“Moody’s”) states that regulators’ “actions have a
14 significant impact on the environment in which a utility operates.”⁵ Moody’s considers
15 the regulatory structure to be so important that 50.00 percent of the factors that weigh in a
16 ratings determination are related to the nature of regulation.⁶ Among the factors
17 considered by Moody’s in assessing the regulatory framework are the effect of regulatory
18 actions on cash flow generation:

19 As the revenues set by the regulator are a primary component of a utility’s
20 cash flow, the utility’s ability to obtain predictable and supportive
21 treatment within its regulatory framework is one of the most significant
22 factors in assessing a utility’s credit quality. The regulatory framework
23 generally provides more certainty around a utility’s cash flow and

³ S&P Global Ratings, RatingsDirect, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, August 10, 2016, at 2.

⁴ *Ibid.*, at 6.

⁵ Moody’s Investor Service, *Consistency and Predictability of Regulatory Decisions Drive Differences in US Utility Credit Profiles*, July 21, 2014, at 2.

⁶ Moody’s Investors Service, Rating Methodology, *Regulated Gas and Electric Utilities*, at 6 (Dec. 23, 2013).

1 typically allows the company to operate with significantly less cushion in
2 its cash flow metrics than comparably rated companies in other industrial
3 sectors.⁷
4

5 In my view, rating agencies would see the Company's proposed alternative ratemaking
6 mechanisms as credit-supportive which, ultimately, is in the best interests of customers
7 and investors.

8 **Q. TURNING TO THE COMPANY'S PROPOSALS, WHY ARE THEY NEEDED AT**
9 **THIS TIME?**

10 A. The proposals are needed to provide the Company a reasonable opportunity to earn its
11 authorized return, and to mitigate (1) the effect of reduced sales volumes on the recovery
12 of revenues authorized by the Commission in the Company's most recent rate case in
13 Docket No. 10-EPDE-314-RTS ("314-Docket"), (2) persistent increases in operating
14 costs and expenses, many of which are outside of the Company's control, and (3) the cost
15 of carrying infrastructure investment not yet reflected in rates. Because those factors are
16 both persistent and generally beyond the Company's control, without the requested
17 regulatory reforms, Empire would need to seek more frequent rate relief to maintain the
18 financial integrity necessary to meet its obligation to provide safe and reliable electric
19 service to customers.

20 **Q. Please describe the trend in the Company's sales.**

21 A. The Company's customer count and sales in Kansas have declined from 2007 to 2017.
22 Over the last eleven years, the total number of retail electric customers has declined 5.50

⁷ Moody's Investors Service, *Regulatory Frameworks – Ratings and Credit Quality for Investor-Owned Utilities*, at 2 (June 18, 2010).

1 percent, from approximately 10,170 in 2007 to approximately 9,600 in 2017.⁸ Sales have
2 declined approximately 13.60 percent during the same period, from approximately 196
3 million kilowatt hours (“kWh”) to 169 million kWh (a compound annual change of -1.45
4 percent).

5 **Q. What effect do declining sales have on the Company and its customers?**

6 A. All else equal, lower sales volumes produce lower revenue, which reduces the
7 Company’s ability to recover its cost of service, putting upward pressure on rates and
8 increasing the burden on customers. Absent the ability to offset lower revenues with cost
9 savings, the result is an inability to earn the Company’s authorized return.

10 **IV. RATEMAKING PRINCIPLES AND THE BENEFITS OF ALTERNATIVE**
11 **RATEMAKING MECHANISMS**

12 **Q. WOULD THE COMPANY AND ITS CUSTOMERS BENEFIT FROM**
13 **REGULATORY REFORM?**

14 A. Yes. As explained below, consistent with universal ratemaking principles, the proposed
15 regulatory reforms provide important benefits to both customers and investors.

16 **Q. WHAT ARE RATEMAKING PRINCIPLES?**

17 A. In his seminal text *Principles of Public Utility Rates*, James C. Bonbright outlined the
18 principles of a sound rate structure, as summarized in Chart 1 below:

⁸ Source: Data provided by the Company.

1

Chart 1: Ratemaking Principles and Regulatory Objectives⁹

Ratemaking Principles	Regulatory Objectives
Economic Efficiency	<ul style="list-style-type: none"> ■ Rates are cost-based ■ Rates encourage efficient consumption of resources (i.e., send proper price signals) ■ Rates encourage prudent cost control
Equity	<ul style="list-style-type: none"> ■ Rates are non-discriminatory ■ Fair allocation of costs and risks ■ Avoidance of cross-subsidization
Revenue Adequacy and Stability	<ul style="list-style-type: none"> ■ Revenue sufficient to ensure financial integrity and encourage new investment ■ Recovery of prudent utility costs ■ Profit stability
Bill Stability	<ul style="list-style-type: none"> ■ Rate stability and continuity ■ Avoidance of rate shock ■ Affordability
Public Acceptance	<ul style="list-style-type: none"> ■ Simplicity ■ Reliable service ■ Understandability ■ Moderate regulatory burden • Promotion of social objectives, e.g., <ul style="list-style-type: none"> • Diverse sources of energy • Utility sponsorship of energy efficiency programs • Environmental policies

2

3

4

5

As discussed below, the Company’s proposed mechanisms reflect those ratemaking principles, and are intended to satisfy the multiple, sometimes conflicting objectives of diverse constituent groups.

6

Q. DO THE COMPANY’S PROPOSED ALTERNATIVE RATEMAKING MECHANISMS PROMOTE ECONOMIC EFFICIENCY?

7

8

A. Yes. The Company’s proposed revenue decoupling mechanism encourages more efficient consumption by breaking the link between sales volume and revenues, removing the disincentive to promote conservation measures.

9

10

⁹ Adapted from: James C. Bonbright, Albert L. Danielsen and David R. Kamerschen, *Principles of Public Utility Rates*, 2nd Edition, Public Utilities Reports (March, 1988); *Alternative Rate Mechanisms and Their Compatibility with State Utility Commission Objectives*, National Regulatory Research Institute, April 2014; *Alternative Electricity Ratemaking Mechanisms Adopted By Other States*, Christensen Associates prepared for Public Utility Commission of Texas, May 25, 2016; *Alternative Regulation for Emerging Utility Challenges: 2015 Update*, Edison Electric Institute, November 11, 2015.

1 **Q. DO THE COMPANY'S PROPOSED ALTERNATIVE RATEMAKING**
2 **MECHANISMS ALSO PROMOTE EQUITY AMONG CONSTITUENT**
3 **GROUPS?**

4 A. Yes, they do. As explained in more detail in Section VI, the Company's proposed
5 revenue decoupling mechanism promotes equity by more fairly enabling the Company's
6 ability to recover its cost of service. Decoupling also may mitigate cross-subsidization
7 that may affect low income and low volume customers.

8 **Q. DO THE COMPANY'S PROPOSED ALTERNATIVE RATEMAKING**
9 **MECHANISMS ALSO ENABLE REVENUE AND BILL STABILITY?**

10 A. Yes, they do. As also discussed in Section VI, the Company's proposed revenue
11 decoupling mechanism stabilizes revenues by mitigating the over- and under-recovery of
12 costs resulting from fluctuations in customer usage. As noted earlier, revenue stability
13 benefits the Company and customers by supporting the Company's financial integrity,
14 enabling it to provide safe and reliable service, and to access capital at reasonable terms.

15 Revenue stability also promotes bill stability. In the traditional cost-of-service
16 framework, rate shock can occur when large capital investments are put into rate base at
17 once. As with the Company's current Asbury Environmental and Riverton Rider
18 ("AERR"), the proposed Capital Tracker would smooth rate effects by collecting the
19 authorized capital investment-related revenue requirement through a separate charge over
20 time. Additionally, under decoupling, actual revenues are reconciled against authorized
21 levels, and rates are adjusted up or down accordingly. Those adjustments, however, are
22 generally small, mitigating rate shock.

1 **Q. ARE THE PROPOSED ALTERNATIVE RATE MECHANISMS GENERALLY**
2 **ACCEPTED BY THE PUBLIC?**

3 A. Yes. As explained below, alternative ratemaking mechanisms are common; a significant
4 number of utilities have implemented mechanisms similar to those proposed by the
5 Company. That is the case because, as with similar structures, the proposed mechanisms
6 would alleviate regulatory lag and support the Company's financial health, thereby
7 diminishing the need to file frequent, costly rate cases. Lastly, as noted earlier, revenue
8 decoupling encourages conservation and the Company's pursuit of energy efficiency
9 measures.

10 **V. ALTERNATIVE RATEMAKING TRENDS IN THE U.S.**

11 **Q. PLEASE DESCRIBE THE RANGE OF ALTERNATIVE MECHANISMS**
12 **IMPLEMENTED BY UTILITIES.**

13 A. Alternative ratemaking mechanisms fall along a spectrum from incremental to
14 comprehensive reform. Mechanisms that represent incremental reform apply to a single
15 component, such as a fuel adjustment mechanism or a future test year. Comprehensive
16 reform mechanisms include ratemaking mechanisms that address the overall revenue
17 requirement, such as revenue decoupling, multiyear rate plans, formula rates, and
18 performance-based rates.

19 **Q. PLEASE GENERALLY EXPLAIN THE TREND IN ALTERNATIVE**
20 **RATEMAKING MECHANISMS IN THE UNITED STATES.**

21 A. Alternative ratemaking mechanisms have been implemented to supplement the traditional
22 ratemaking process, principally to mitigate regulatory lag. Cost recovery adjustment

1 mechanisms arose from the need to address rapidly rising fuel costs during the early
2 1970s, when fuel prices increased more rapidly than utilities could recover the increased
3 costs through the traditional rate case process. During that time, utility earnings were
4 under considerable pressure, prompting jurisdictions to allow more timely recovery of
5 cost increases beyond utilities' control.¹⁰

6 Alternative ratemaking has been of increased interest in recent years, due to rising
7 and volatile utility costs, growth in non-revenue producing capital expenditures, and
8 sluggish demand growth. Declining load and slow economic growth has placed pressure
9 on traditional volume-based, cost-of-service ratemaking. Further, sending a usage-based
10 price signal to recover costs that generally do not vary based on that usage is not
11 economically efficient, and therefore is largely inconsistent with the ratemaking principle
12 of "cost causation".

13 More recently, states have pursued public policy initiatives and have developed
14 mechanisms to support and advance those policies. For electric utilities, alternative
15 ratemaking mechanisms therefore have been spurred by flat load growth, increased costs
16 to meet environmental mandates, state-mandated energy efficiency programs, and a
17 desire to support utility financial performance.

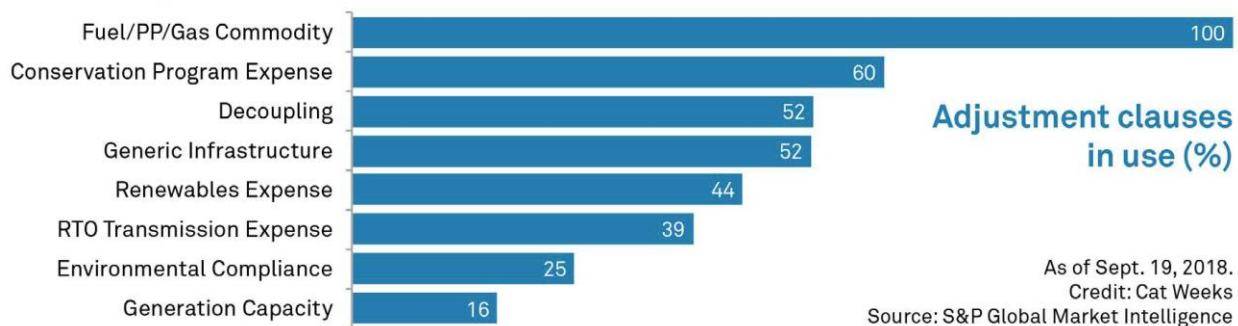
18 **Q. ARE ALTERNATIVE RATEMAKING MECHANISMS COMMON IN THE U.S.?**

19 A. Yes, they are. As shown on Chart 2 below, according to Regulatory Research Associates
20 ("RRA"), all utilities have a mechanism to recover fuel, purchased power, or gas
21 commodity costs. Further, more than half of the utilities covered by RRA have generic

¹⁰ Source: Regulatory Research Associates, *Adjustment Clauses: A State-by-State Overview*, September 28, 2018, at 2.

1 infrastructure cost recovery or revenue decoupling mechanisms in place, and 60.00
2 percent have mechanisms to recover energy efficiency program expenses.

3 **Chart 2: Cost Recovery Adjustment Mechanisms in Use at U.S. Utilities¹¹**



5 More comprehensive forms of alternative mechanisms, such as multiyear rate plans and
6 formula rate plans, have been implemented in 24 states.¹²

7 **VI. THE COMPANY'S PROPOSED ALTERNATIVE RATEMAKING**
8 **MECHANISMS**

9 ***Revenue Decoupling***

10 **Q. PLEASE DESCRIBE THE PRIMARY OBJECTIVES OF DECOUPLING**
11 **MECHANISMS.**

12 A. The term “decoupling” encompasses a category of alternative ratemaking mechanisms
13 designed to decouple, or break, the link between a utility’s revenue and its volume of
14 sales. Decoupling mechanisms are intended to align the interests of customers and
15 shareholders by allowing the utility to recover its authorized revenues, while supporting
16 programs to promote energy efficiency.

¹¹ *Ibid.*, at 3.

¹² Source: Lowry, Makos, Waschbusch, *Alternative Regulation for Emerging Utility Challenges: 2015 Update*, prepared for the Edison Electric Institute, November 11, 2015.

1 A central premise of decoupling is that the utility’s costs of providing service
2 primarily do not vary with sales volume (*i.e.*, kWh sales). Like other utilities, Empire
3 incurs customer-related and demand-driven costs to provide electric service that generally
4 are not affected by its sales volume in the short run. By “decoupling” revenues from the
5 volume of sales, the Company is better able to recover its revenue requirement when
6 customers consume less electricity. Under that structure, the Company would be
7 indifferent to changes in customer usage due to factors beyond its control.

8 **Q. PLEASE PROVIDE SOME EXAMPLES OF “CUSTOMER-RELATED” AND**
9 **“DEMAND-DRIVEN” COSTS THAT ARE INCURRED BY THE COMPANY.**

10 A. Customer-related costs are those incurred to serve customers regardless of the amount of
11 energy consumed, and may include billing, meter reading, collections, call centers,
12 meters, and other infrastructure and expenses necessary to connect customers to the
13 electric system. Demand-driven costs are the system investments necessary to meet
14 customers’ peak demands on the system. Such costs may include, for example,
15 generation and power plant equipment that is sized, constructed, and maintained to meet
16 customers’ peak demands. Once the Company makes these investments to serve
17 customers and meet peak demand, the costs do not vary based on sales volumes (*i.e.*,
18 kWh sales).

19 **Q. WHY IS DECOUPLING AN APPROPRIATE RATEMAKING MECHANISM**
20 **FOR THE COMPANY?**

21 A. Although the Company’s cost of providing electric service is not principally driven by
22 sales, a significant portion of its revenue is recovered through volume-based charges. As

1 discussed in more detail in Mr. Lyons' testimony, this mismatch between utility costs and
2 rates creates a corresponding mismatch between cost causation and cost recovery.

3 For example, a large majority of the Company's cost of providing electric service
4 does not change with kWh sales in the short run. However, at current rates, more than
5 81.00 percent of residential revenue is recovered based on consumption through variable,
6 volume-based charges.¹³ Figure 10 of Mr. Lyons' testimony provides the percentage of
7 volume-based revenues by rate class, demonstrating that a significant portion of the
8 Company's revenues are recovered through volumetric rates.

9 **Q. WHAT FACTORS CONTRIBUTE TO FLUCTUATIONS IN SALES VOLUMES?**

10 A. There are several factors that contribute to the fluctuations in customer usage for an
11 electric utility. For many utilities, a significant contributor to that variation is weather,
12 particularly fluctuations in temperature. Warmer-than-normal summer temperatures lead
13 to higher consumption, whereas cooler-than-normal summer temperatures lead to lower
14 consumption.¹⁴ Other factors may include customer-initiated conservation efforts,
15 installation of distributed energy resources ("DER"), changes in the number of
16 customers, as well as federal, state, and local economic factors.

17 **Q. DO OTHER UTILITIES EXPERIENCE SIMILAR OVER- AND UNDER-
18 RECOVERY OF COSTS?**

19 A. Yes. This type of over- and under-recovery of costs is not unique to Empire – it is a
20 challenge for the electric industry. Electric utilities in 31 jurisdictions therefore have

¹³ Direct Testimony of Timothy S. Lyons, at Figure 10. Represents the simple average of the three Residential rate classes: Residential General, Residential General - Water Heating, and Residential Total Electric.

¹⁴ Consumption from electric heating rate classes would increase in colder-than-normal winter weather and decrease in warmer-than-normal winter weather, however.

1 mechanisms in place to decouple revenues from sales volume, in a full or limited
2 fashion.¹⁵

3 **Q. Please describe briefly the Company’s proposed Revenue Stabilization Rider.**

4 A. As explained in more detail by Mr. Lyons, the Company’s proposed Revenue
5 Stabilization Rider would reconcile, on a monthly basis, differences between actual and
6 authorized revenues (*i.e.*, revenues reflected in current base rates that were approved by
7 the Commission in the most recent rate case proceeding), thereby mitigating the over-
8 and under- recovery of revenues resulting from variations in customer usage.

9 **Q. WHAT ARE THE BENEFITS OF THE REVENUE STABILIZATION RIDER?**

10 A. The Revenue Stabilization Rider is a symmetrical and transparent formula for collecting
11 the approved distribution revenue requirements – no more, no less. In addition, the
12 Revenue Stabilization Rider reduces the reliance on an imperfect forecasting process and
13 diminishes the advantage a utility has in choosing the timing of the next rate case.
14 Because fluctuations in weather and general economic conditions are beyond the
15 Company’s control, the Revenue Stabilization Rider allows the Company to focus on
16 factors it can control to provide safe and reliable service. The Revenue Stabilization
17 Rider also reduces cross-subsidization between low volume and higher volume
18 customers, and protects customers against the negative effects of declining load and
19 revenue reductions attributable to energy efficiency programs and the installation of

¹⁵ See Regulatory Research Associates, “Adjustment Clauses: A State-by-State Overview” September 28, 2018; American Council for an Energy Efficient Economy, Utility Business Model State and Local Policy Database (<https://database.aceee.org/state/utility-business-model>). Includes lost revenue adjustment mechanisms for energy-efficiency programs.

1 DER. The Revenue Stabilization Rider therefore encourages customer-initiated and
2 utility-sponsored energy efficiency measures.

3 The Revenue Stabilization Rider also ensures customer bills are more stable over
4 the longer term. To the extent actual revenues were higher than approved levels in a
5 given month (and therefore bills for distribution service were higher than anticipated),
6 rates would be reduced. The converse also would be true in that if revenues (and bills)
7 were lower than anticipated, rates would increase. The Revenue Stabilization Rider
8 therefore smooths customer bills over the longer term, such that the rates customers pay
9 recover only the approved revenue levels. As such, the decoupling mechanism ensures
10 customers pay no more than the amount authorized by the Commission.

11 As explained earlier, revenue stability is an important ratemaking principle that
12 has long-governed regulatory commissions' rate-setting objectives.¹⁶ The Revenue
13 Stabilization Rider provides revenue stability enabling the Company to recover its cost of
14 service, the majority of which does not change based on kWh sales. The Revenue
15 Stabilization Rider therefore supports Empire's ability to provide safe, reliable and
16 efficient service to its customers.

17 **Q. IF DECOUPLING REMOVES THE LINK BETWEEN SALES AND REVENUES,**
18 **DOES IT GUARANTEE A UTILITY WILL EARN ITS AUTHORIZED RATE OF**
19 **RETURN?**

20 A. No, it does not. Decoupling only addresses the revenue component of the income
21 statement, not operating expenses or rate base investments. As explained earlier, under

¹⁶ See, James C. Bonbright, Albert L. Danielsen and David R. Kamerschen, Principles of Public Utility Rates, 2nd Edition, Public Utilities Reports (March 1988), at 382-384, 387-388.

1 traditional cost-of-service ratemaking, utilities rely on incremental revenues beyond the
2 rate case rate year as a means of maintaining a reasonable rate of return on investment in
3 between rate cases. Those additional funds historically have financed necessary capital
4 investments, and helped offset inflationary pressures. When the costs of providing service
5 escalates faster than sales (and therefore revenue), over time the utility's rate of return
6 will likely erode. Stable, predictable revenues over time help the utility to maintain a
7 reasonable level of earnings, and to avoid frequent and costly rate cases. Decoupling
8 mechanisms therefore may stabilize a utility's revenues and support its financial integrity,
9 enabling the utility to provide safe and reliable service to customers. They do not,
10 however, guarantee a base level of earnings or rate of return, nor do they create windfall
11 profits for the utility.

12 *Cost Recovery Adjustment Mechanisms*

13 **Q. PLEASE EXPLAIN, GENERALLY, THE PURPOSE OF COST RECOVERY**
14 **ADJUSTMENT MECHANISMS.**

15 A. As discussed earlier, cost recovery adjustment mechanisms have been implemented by
16 utilities to provide more timely recovery of costs between rate cases since the 1970s. As
17 a principle, these adjustment mechanisms have been implemented to recover costs that
18 are large, volatile, and/or exogenous (that is, beyond the utility's control). More recently,
19 adjustment mechanisms have been implemented to address public policies mandated by
20 legislation or by regulatory decisions. Examples include recovery of energy efficiency
21 programs and environmental compliance costs, such as the Company's current AERR.

1 **Q. WHAT IS THE COMPANY PROPOSING IN THIS PROCEEDING WITH**
2 **RESPECT TO COST RECOVERY MECHANISMS?**

3 A. The Company proposes two cost recovery mechanisms. First, as explained further by
4 Mr. Lyons, the Company proposes a Capital Tracker Rider mechanism to recover the
5 revenue requirement associated with incremental investment in (1) grid resiliency, (2)
6 generation capacity; and (3) other investments. Second, as Mr. Doll explains, consistent
7 with Kansas statute, the proposed TDC Rider would recover transmission-related costs
8 associated with service to its Kansas-jurisdictional customers.

9 **Q. ARE SIMILAR MECHANISMS IN PLACE AT OTHER ELECTRIC UTILITIES?**

10 A. Yes. As shown in Chart 2 above, more than half of the utilities covered by RRA have a
11 generic infrastructure capital cost recovery mechanism. Additionally, 39.00 percent have
12 a mechanism to recover Regional Transmission Organization (“RTO”) charges, such as
13 the Company’s transmission costs associated with participation in the Southwest Power
14 Pool (“SPP”) and Midcontinent Independent System Operator (“MISO”) included in the
15 proposed TDC.¹⁷

16 **Q. HOW DO CUSTOMERS BENEFIT FROM THE PROPOSED COST RECOVERY**
17 **ADJUSTMENT MECHANISMS?**

18 A. First, the proposed mechanisms stabilize customer bills and mitigate rate shock by
19 phasing in over time the costs associated with the investments, which smooths the rate
20 impact of recovering these costs. Additionally, the proposed mechanisms would support
21 the Company’s ability to maintain its financial integrity, to the benefit of customers. A

¹⁷ See, Direct Testimony of Aaron J. Doll.

1 financially healthy utility has a greater capacity to withstand adverse changes in business
2 and market conditions, and to invest in its system to provide safe and reliable service.
3 Further, a utility's credit rating reflects its financial integrity; a higher credit rating results
4 in lower debt costs for customers. Lastly, the proposed mechanisms mitigate regulatory
5 lag, thus reducing the need for more frequent costly rate cases.

6 **Q. WHY SHOULD THE COMMISSION APPROVE THE COMPANY'S PROPOSED**
7 **COST RECOVERY ADJUSTMENT MECHANISMS?**

8 A. The proposed mechanisms alleviate the challenge of eroding revenues and increasing
9 costs, while providing benefits to customers. Without timely cost recovery, certain of
10 these important expenditures might be deferred or reduced. Moreover, the investments
11 proposed for recovery are non-revenue producing. That is, the investments do not
12 generate additional revenues for the Company to offset the expenditures being made.
13 Finally, such mechanisms can reduce the need for the Company to file more frequent and
14 costly general rate case filings. For these reasons, the Commission should approve the
15 Company's proposed cost recovery adjustment mechanisms.

1 **Q. WITH RESPECT TO USING THESE MECHANISMS TO DELAY THE FILING**
2 **OF MORE FREQUENT COSTLY GENERAL RATE CASE FILINGS, WHAT IS**
3 **THE ESTIMATED COST OF FILING THIS GENERAL RATE CASE?**

4 A. Empire has estimated the cost of filing this general rate case to be more than \$640,000.¹⁸
5 This cost is significant given the fact that Empire serves less than 10,000 customers in
6 Kansas.

7 **VII. SUMMARY AND CONCLUSIONS**

8 **Q. PLEASE BRIEFLY SUMMARIZE YOUR TESTIMONY.**

9 A. The Company's proposed rate reforms arise from circumstances that have affected many
10 electric utilities throughout the Country. The difficult combination of flat or declining
11 customer usage, sustained capital investments, and volatile operating costs has created a
12 circumstance in which it will become increasingly challenging under traditional cost-of-
13 service ratemaking to maintain the strong financial profile that benefits both customers
14 and investors. The proposed structures are meant to address that financial strain, support
15 the financial profile needed to continue providing safe and reliable service, while
16 reducing the need for frequent rate filings.

17 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

18 A. Yes, it does.

¹⁸ Data provided by the Company.

