BEFORE THE STATE CORPORATION COMMISSION OF THE STATE OF KANSAS

In the Matter of the Application of Kansas Gas Service, a Division of ONE Gas, Inc. for Adjustment of its Natural Gas Rates in the State of Kansas.	))))	Docket No. 24-KGSG-610-RTS

DIRECT TESTIMONY

OF

MARK W. SMITH

ON BEHALF OF KANSAS GAS SERVICE

A DIVISION OF ONE GAS, INC.

MARCH 1, 2024

AMENDED

APRIL 22, 2024

DIRECT TESTIMONY AMENDED
OF
MARK W. SMITH
ON BEHALF OF KANSAS GAS SERVICE
A DIVISION OF ONE GAS, INC.
DOCKET NO. 24-KGSG-610-RTS

I. Position and Qualifications

Q. Please state your name and business address.

A. My name is Mark W. Smith, and my business address is 15 E. 5th Street Tulsa, Oklahoma 74103.

Q. By whom are you employed and in what capacity?

A. I am the Vice President and Treasurer for ONE Gas, Inc. ("ONE Gas") and its division Kansas Gas Service ("KGS" or the "Company").

Q. Please describe your education and professional experience.

A. I have a Bachelor of Science in Accounting from Oklahoma State University, a Master's Degree in Business Administration from Phillips University, and I am also a Certified Public Accountant. I have testified in cases before the Kansas Corporation Commission ("Commission"), the Oklahoma Corporation Commission, Railroad Commission of Texas, and Federal Energy Regulatory Commission ("FERC"). I previously served on the Southern Gas Association Rate Committee where I taught a portion of its Regulatory 101 course. I have worked for ONE Gas or ONE Gas' predecessor, ONEOK, Inc., for over 37 years in areas that include Rates and Regulatory, Corporate Accounting, Budgeting, Corporate Development, and Treasury.

Q. Was this testimony prepared by you or under your direct supervision?

A. Yes, either I or employees under my direction prepared this testimony and the accompanying exhibits.

Q. Have you previously testified before this Commission?

A. Yes, I filed testimony before this Commission in Docket Nos. 00-KGSG-786-ACQ, 12-KGSG-835-RTS, 16-KGSG-491-RTS, 17-KGSG-455-ACT, 18-KGSG-560-RTS, 21-KGSG-332-GIG, and 22-KGSG-446-TAR. I have also testified before the Oklahoma Corporation Commission, the Railroad Commission of Texas and FERC.

II. Executive Summary

Q. Please summarize the key issue(s) you address.

A. My testimony will address: (1) the Company's capital structure, (2) a background in financial markets, (3) sponsor section 7 of the filing, and (4) support the Company's requested return on equity ("ROE").

Q. Please summarize your recommendation with respect to the overall rate of return for Kansas Gas Service.

A. I recommend that the Commission authorize KGS to have an opportunity to earn an overall rate of return of 7.89 percent based on its actual capital structure for the period ending December 31, 2023, adjusted for current maturities that have already been refinanced, resulting in a capital structure of 40.42 percent long-term debt and 59.58 percent common equity. The overall rate of return is summarized in Table MWS-1 below:

Table MWS-1: Summary of Overall Rate of Return

Description	Adjusted Capital Structure	Capital Structure	Debt & Equity Returns	Weighted Return
Long-Term Debt	$ 1,876,670	40.42%	4.3993%	1.7783%
Common Equity	$ 2,765,878	59.58%	10.2500%	6.1066%
Total	$ 4,642,548	100.00%		7.8849%

III. Company's Capital Structure

Q. Why is KGS using the capital structure that existed on December 31, 2023?

A. A portion of ONE Gas debt was refinanced in December 2023, which is not reflected in the test year ending capital structure. This removes debt that was refinanced in December 2023 and paid off on February 1, 2024. In addition, KGS removed the last of the short-term debt that was borrowed for Winter Storm Uri which matures on March 10, 2024. ONE Gas had a $300 million note mature on February 1, 2024, that had a rate of 3.61 percent. This note was refinanced with a $300 million note with a 5.10 percent rate on December 13, 2023. The remaining Winter Storm Uri debt was held to maturity as short-term debt because the rate was more favorable than what the company could borrow in the short-term commercial paper market. As of this filing the $300 million long-term note has been paid off and refinanced with a new $300 million note. Additionally, the $473 million of Winter Storm Uri debt will also be paid off and refinanced with commercial paper in March 2024.

Q. Why was the $473 million of Winter Storm Uri debt not paid off earlier?

A. The securitization of ONE Gas' Texas division was not finalized until 2023. At which time ONE Gas could have paid this note off or paid down commercial paper. The note had less than one year to maturity and was at a rate that was lower than the commercial paper rate, therefore the Company elected to pay down commercial paper and consider this note as part of its short-term borrowings.

Q. Is a capital structure with 59.58% equity percentage reasonable for KGS based on ONE Gas' ongoing capital structure?

A. Yes, as shown in Table MWS-2 ONE Gas has maintained this capital structure (excluding the Winter Storm Uri debt and any securitized debt associated with Kansas Gas Service Securitization I ("KGSS-I")) since its separation. In fact, the equity percentage has ranged from a low of 57.~~90~~91% to a high of 62.~~35~~37%. I will discuss the need for this capital structure later in my testimony.

Table MWS-2: Historical Cost of Capital for ONE Gas, Inc.

Year Ended December 31,	Long-Term Debt	Less: Winter Storm Uri Debt Maturing On March, 2024	Less: Fort Sill Debt related to ONG	Less: Debt Maturing on Februay 1, 2024	Less: KGSSI Securitization	Net Long-Term Debt	Equity	Total Capital	Percent Long-Term Debt	Percent Equity
2014	$ 1,201,318	$ -	$ (1,318)	$ -	$ -	$ 1,201,318	$ 1,794,036	$ 2,995,354	40.11%	59.89%
2015	$ 1,201,311	$ -	$ (1,311)	$ -	$ -	$ 1,201,311	$ 1,841,556	$ 3,042,867	39.48%	60.52%
2016	$ 1,192,454	$ -	$ (1,304)	$ -	$ -	$ 1,192,454	$ 1,888,281	$ 3,080,734	38.71%	61.29%
2017	$ 1,193,264	$ -	$ (1,297)	$ -	$ -	$ 1,193,264	$ 1,960,209	$ 3,153,473	37.84%	62.16%
2018	$ 1,285,492	$ -	$ (1,289)	$ -	$ -	$ 1,285,492	$ 2,042,657	$ 3,328,149	38.62%	61.38%
2019	$ 1,286,074	$ -	$ (1,281)	$ -	$ -	$ 1,286,074	$ 2,129,390	$ 3,415,464	37.65%	62.35%
2020	$ 1,582,438	$ -	$ (1,272)	$ -	$ -	$ 1,582,438	$ 2,233,311	$ 3,815,749	41.47%	58.53%
2021	$ 3,683,389	$ (2,100,000)	$ (1,261)	$ -	$ -	$ 1,583,389	$ 2,349,533	$ 3,932,922	40.26%	59.74%
2022	$ 2,682,471	$ (473,000)	$ (1,250)	$ -	$ (330,060)	$ 1,879,411	$ 2,584,426	$ 4,463,837	42.10%	57.90%
2023	$ 2,960,816	$ (473,000)	$ (1,238)	$ (299,971)	$ (309,936)	$ 1,876,670	$ 2,765,878	$ 4,642,548	40.42%	59.58%
Average						$ 1,428,182	$ 2,158,928	$ 3,587,110	39.67%	60.33%

~~* (Thousands of dollars)~~

Year Ended December 31,	Long-Term Debt	Less: Winter Storm Uri Debt Maturing On March, 2024	Less: Fort Sill Debt related to ONG	Less: Debt Maturing on Februay 1, 2024	Less: KGSSI Securitization	Net Long-Term Debt	Equity	Total Capital	Percent Long-Term Debt	Percent Equity
2014	$ 1,201,318	$ -	$ (1,318)	$ -	$ -	$ 1,200,000	$ 1,794,036	$ 2,994,036	40.08%	59.92%
2015	$ 1,201,311	$ -	$ (1,311)	$ -	$ -	$ 1,200,000	$ 1,841,556	$ 3,041,556	39.45%	60.55%
2016	$ 1,192,454	$ -	$ (1,304)	$ -	$ -	$ 1,191,149	$ 1,888,281	$ 3,079,430	38.68%	61.32%
2017	$ 1,193,264	$ -	$ (1,297)	$ -	$ -	$ 1,191,967	$ 1,960,209	$ 3,152,176	37.81%	62.19%
2018	$ 1,285,492	$ -	$ (1,289)	$ -	$ -	$ 1,284,203	$ 2,042,657	$ 3,326,859	38.60%	61.40%
2019	$ 1,286,074	$ -	$ (1,281)	$ -	$ -	$ 1,284,793	$ 2,129,390	$ 3,414,183	37.63%	62.37%
2020	$ 1,582,438	$ -	$ (1,272)	$ -	$ -	$ 1,581,166	$ 2,233,311	$ 3,814,477	41.45%	58.55%
2021	$ 3,683,389	$ (2,100,000)	$ (1,261)	$ -	$ -	$ 1,582,128	$ 2,349,533	$ 3,931,660	40.24%	59.76%
2022	$ 2,682,471	$ (473,000)	$ (1,250)	$ -	$ (330,060)	$ 1,878,161	$ 2,584,428	$ 4,462,589	42.09%	57.91%
2023	$ 2,960,816	$ (473,000)	$ (1,238)	$ (299,971)	$ (309,936)	$ 1,876,670	$ 2,765,878	$ 4,642,548	40.42%	59.58%
Average						$ 1,427,024	$ 2,158,928	$ 3,585,951	39.65%	60.35%

Q. Is this capital structure consistent with what ONE Gas was granted in its last several cases in other jurisdictions?

A. Yes, in a settlement that was just filed in Texas for the Rio Grande Valley service area a capital structure with a 59.07% equity percentage was used. Also in Texas, in a litigated case for the West-North service area an equity percentage of 59.74% was approved in January 2023, and in the Central-Gulf service area an equity percentage of 59% was approved in August 2020. Additionally, in Oklahoma a 58.55% equity percentage was approved in November 2021. In all of these examples, the equity percentage was reflective of ONE Gas' actual capital structure, adjusted for known and measurable changes following the test year.

Q. Has this Commission allowed a capital structure with a similar equity layer?

A. Yes. In Atmos Energy Corporation's most recent rate case, Docket No. 23-ATMG-359-RTS, parties were able to reach a unanimous settlement agreement on the case. In Commission Staff's ("Staff") testimony in support of the agreement, Staff spoke to how a pre-tax rate of return fit within Staff, the Citizens' Utility Ratepayer Board ("CURB"), and Atmos' proposed capital structures. This analysis, performed on pages 14 and 15 of Staff Witness Mr. Justin Grady's testimony on the settlement, was done to show how differing opinions on capital structure and ROE can nevertheless result in the same pre-tax rate of return. Since KGS's capital structure is in-line with the capital structure proposed by Staff and analyzed in the Atmos settlement, there is support for accepting KGS's adjusted capital structure as it existed in December 2023. For example, when evaluating Atmos' capital structure, Staff utilized a capital structure of 59.16% common equity. KGS is proposing a capital structure of 59.58% common equity.

Q. Why is it important for the Commission to allow KGS its actual capital structure and cost of capital?

A. It is important for the Commission to allow KGS to utilize its actual capital structure and cost of capital in determining its revenue requirement for several reasons. Capital structure and cost of capital impact a wide spectrum of the utility's operations: from the financial viability of the utility, the incentive for investors to invest in the Company and have an opportunity to earn an appropriate return for its risk, to ensuring ONE Gas has access to low-cost debt and to provide regulatory stability.

Allowing KGS its actual capital structure and cost of capital ensures the Company can attract the necessary investment to maintain and expand its infrastructure. This is essential for the long-term financial viability of the utility, which ultimately benefits consumers by ensuring safe, reliable and efficient service. KGS requires significant capital investment to upgrade aging infrastructure, improve service quality, meet other regulatory requirements and extend service to new customers. Allowing KGS its actual capital structure and cost of capital provides the crucial financial support for the Company to make these necessary investments, ultimately benefiting customers and the broader 360 communities KGS serves.

KGS and ONE Gas' other divisions operate in a regulated environment and are subject to strict regulatory oversight. Allowing KGS its actual capital structure and cost of capital enables the Company to earn a fair return on its investments, compensating for the risks associated with operating in an industry subject to changing federal and state regulatory requirements and regulatory decisions.

The actual capital structure and cost of capital reflects the actual cost of debt and equity financing for KGS. By allowing KGS its actual capital structure and cost of capital, regulators can ensure that the Company has access to cost-effective financing, which can help keep consumer costs in check.

Allowing KGS its actual capital structure and cost of capital can contribute to regulatory stability by providing clarity and predictability for KGS and ONE Gas' financial planning and investment decisions. This, in turn, can promote a more efficient and stable regulatory environment. Overall, allowing KGS its actual capital structure and cost of capital can help strike a balance between the interests of customers, KGS, ONE Gas, and investors, , ultimately contributing to the overall efficiency and effectiveness of KGS's operations.

IV. Background in Financial Markets

Q. Could you please summarize your experience in working with financial markets and capital structure issues?

A. I have over 20 years of experience managing the treasury function for ONE Gas (and its predecessor company). During this time, I dealt with financial crises related to September 11, 2001, the 2008 financial crisis, the COVID-19 outbreak and related financial crisis, the 2021 Winter Storm Uri event and the current inflationary pressures being experienced nationwide. In addition to dealing with these financial crises and issues, I have firsthand knowledge and understanding of what equity investors and bond investors are looking for when making an investment. I worked through crises when the Company had a “BBB” credit rating and know what to expect when a company has a low investment grade credit rating. Also, I understand the importance of a strong credit rating, and correspondingly, what to expect from the credit and equity markets.

Q. Do you believe it is important for the Commission to allow the Company its actual capital structure for ratemaking purposes and do you think it is important for ONE Gas to maintain the capital structure it has held since separation?

A. Yes. Capital structure recommendations need to be evaluated in the context of current market conditions and the potential impact those recommendations may have on the Company's financial stability. I explain below how a deviation from the Company's actual capital structure would harm ONE Gas, KGS and, correspondingly, customers, by increasing the cost of debt for ONE Gas. With uncertainty in the financial and debt markets expected to continue through 2024, deviating from the Company's actual capital structure would make ONE Gas' ability to address and manage a major weather event, such as Winter Storm Uri, more difficult.

Q. Are there any common misconceptions around the cost of debt?

A. Yes. Many consultants view debt as if it were a personal mortgage with interest and principal being paid every month when, in fact, it is an investment to a bondholder that is traded daily just like stock. Corporate bonds, unlike individual mortgages, typically have semi-annual interest payments and the principal is not due until the end of the term. Additionally, bonds are almost always refinanced with new bonds when they come due. In 2019, for example, $300 million of ONE Gas' 5-year notes that were put in place when it separated from ONEOK in 2014 were refinanced with $400 million of new 10-year bonds. In December 2023, ONE Gas issued $300 million of 5-year notes at a rate of 5.10% to replace the maturing $300 million of 10-year notes with a rate of 3.61% that ONE Gas issued at the time of its separation from ONEOK in 2014. Therefore, bonds should be considered to be similar to equity which trades on an open market and for which a willing buyer is needed to be able to issue more debt.

Q. Are there any similarities between a personal mortgage and a company's cost of debt?

A. One similarity that exists is the extent to which the ratings agencies rely on cash flow when assessing financial stability. In the same manner that a bank assesses an individual's gross income and expenses when deciding whether to lend that person money (and at what rate) to purchase a home, ratings agencies are diligent about assessing cash flow for companies when issuing a rating that impacts the rate for bonds issued. Ratings agencies rate more than specific companies – they rate individual bond issuances. Thus, as with the case of a person seeking a home mortgage, if a company does not have strong cash flow, the company may not be able to find an investor willing to purchase its debt or may have to pay more for that debt in order to attract an investor (i.e., pay a higher interest rate).

Q. Can you explain how bonds trade like stock on an open market exchange?

A. Yes. Bonds trade daily just like stock based on investor interest, and their value goes up and down depending on several factors. For instance, the value of a bond increases when the underlying U.S. Treasury rates go down. Bonds decrease in value when the underlying U.S. Treasury rates go up. The credit spread on a bond can also impact the value of the bond. The "spread" is a risk premium placed on a company's bond over the rate of the underlying U.S. Treasury (commonly thought of as a risk-free investment). For instance, the spread for ONE Gas in December 2019, prior to the COVID-19 crisis, was 85 basis points or 0.85% above the 10-year U.S. Treasury. In the last three weeks of March 2020, this spread ranged between 270 basis points, or 2.70%, up to 470 basis points, or 4.70%. In January of this year, the spread was 105 basis points or 1.05% up to 115 basis points or 1.15%. The lower the credit rating of a company the higher they can expect their spread to be during times of increasing U.S. Treasury rates or market instability. The higher credit rated a company, the lower the spread or risk premium. So, investors in bonds are always looking at more than just the stated interest rate on the bond or coupon. To determine the value to place on a company's bond, investors look at: (i) whether the U.S. Treasury rates are rising or falling; (ii) whether spreads are widening (getting bigger) or tightening (getting smaller); (iii) what the financial metrics of a company are indicating; (iv) whether the company is operating in a manner consistent with maintaining its credit rating; and (v) the overall economy.

Q. Are investments in utility bonds risk-free?

A. No, investments in utility bonds are not risk-free. Utility bonds, like any other type of bond, carry inherent risks. These risks include interest rate risk, credit risk, market risk, regulatory risk, and liquidity risk. Changes in interest rates can affect the value of utility bonds. If interest rates rise, the value of existing bonds may decrease, and vice versa. Utility bonds are subject to credit risk, which is the risk that the issuer may default on its debt obligations. This risk is higher for company bonds that have lower-ratings and can vary depending on the financial health and creditworthiness of the utility issuing the bond. Utility bonds are also exposed to market risk, which is the risk of price fluctuations due to changes in market conditions, economic factors, or investor sentiment. Utilities are often subject to regulatory oversight, and changes in regulations can impact the financial performance of the utility, thereby affecting the value of its bonds. Utility bonds may also carry liquidity risk, meaning that they may be difficult to sell at a reasonable price if there is a lack of demand in the market. Corporate investors in bonds are exposed to risk just like equity holders are exposed to risk. However, in the event of bankruptcy, they receive funds prior to equity holders, should there be a liquidation.

Q. What happens to a bondholder and how do they react when a company's rating by a rating agency is downgraded?

A. As I previously explained, bonds are traded on the open market and investors are watching a company's credit rating because these ratings affect the price of the bond.

When a company's bonds are downgraded by Moody's Investors Service ("Moody's") and/or Standard and Poor's ("S&P"), the credit spread on the debt increases, the bonds have a lower value, and, unless the investor can hold the bond to maturity, the investor loses money. Some investment managers' "Investment Thesis" will only allow them to hold "A" rated bonds or higher and they would be forced to sell the downgraded bonds at a loss. The investors often hold a company accountable for not maintaining its rating by not participating in future debt offerings by that company or may require a higher spread on future bonds to account for the extra risk they associate with not knowing if a company will do what it must to maintain its rating. ONE Gas experienced this when ONE Gas separated from ONEOK. ONEOK's bonds went from "BBB" to non-investment grade. Many of the bond investors were forced to sell their bonds at a loss. When ONE Gas was marketing its bonds just prior to the separation, investors indicated that they lost money on the ONEOK bonds and therefore would not participate in the new ONE Gas bond offering. Thus, ONE Gas had fewer willing buyers during the initial debt offering. The decreased number of buyers makes it difficult to tighten the price spread and get the best rate, which will ultimately impact the Company's customers.

Q. Does a downgrade in the bond market impact the equity market or a company's ability to issue equity?

A. Yes, investment managers will view the company as a riskier investment, which will decrease the valuation of the company's stock, thus increasing equity cost. A downgrade will signal to financial markets that the risk of the company fulfilling its financial obligations is higher. Therefore, the price of and demand for the stock is likely to drop.

Q. How is ONE Gas currently viewed in the market?

A. By being a 100% regulated utility with a strong balance sheet, ONE Gas is viewed as a creditworthy company that can attract capital. However, as I note above, regulatory decisions, like the outcome of this rate proceeding, have the potential to change the way both bond and equity investors perceive the risk of a current or future investment in ONE Gas. Additionally, utilities are already out of favor as overnight rates and Treasury rates have started yielding interest rates higher than utilities' dividend yields. This has forced utility stock prices lower and as a result is making the cost of debt and equity more expensive.

Q. How is the Commission's decision in this case likely to affect ONE Gas' cost of debt?

A. Regulatory risk can have a significant impact on the value of ONE Gas bonds. Regulatory risk refers to the uncertainty and potential negative impact on a utility's financial performance due to changes in regulations or regulatory decisions. This risk can affect the value of ONE Gas' bonds in several ways. Regulatory changes, such as adjustments to rates or changes in allowed return on investment, can directly impact KGS's revenue and cash flow. ONE Gas' cost of debt is directly tied to its credit rating, which is directly dependent on the cash flow metrics that result from the rates approved by the Commission in this case. My testimony above demonstrates that if the Commission adopts a negative position on capital structure, the financial stability of ONE Gas would be weakened, putting ONE Gas at risk for a credit ratings downgrade. A downgrade, if it occurs, would result in customers paying a higher cost of debt for financing investments in the safety of the Company's system and could limit KGS's ability to make new investments in its system to support growth in the Kansas communities it serves. Additionally, if regulators approve lower-than-expected rate increases or impose stricter operating conditions, it can reduce KGS's and ONE Gas' ability to generate sufficient cash flow to meet its debt obligations, potentially affecting the value of its bonds. Regulatory risk can influence ONE Gas' credit rating, which in turn affects the perceived creditworthiness of ONE Gas and its bonds. Negative regulatory developments could prompt credit rating agencies to downgrade ONE Gas' credit rating, leading to a decrease in the value of its bonds. Uncertainty surrounding regulatory decisions and their potential impact on KGS's and ONE Gas' financial outlook can affect investor sentiment. If investors perceive increased regulatory risk, they may demand higher yields on ONE Gas' bonds to compensate for the perceived additional risk, leading to lower bond prices. Regulatory uncertainty can impact KGS and ONE Gas' ability to make long-term investment decisions, such as decisions related to capital expenditures for infrastructure upgrades or expansion. This can affect the overall financial health and stability of ONE Gas, potentially impacting the value of its bonds. Overall, regulatory risk can introduce uncertainty and influence investor perceptions of ONE Gas' financial prospects, potentially leading to changes in bond prices and yields.

Q. What factors contribute to a utility's financial stability?

A. The financial stability of a regulated utility is largely a function of its capital structure, ROE, and cash flow. To maintain a strong financial profile, a utility needs to have the opportunity to recover prudently incurred utility costs in a timely manner, which include not only the costs of operation and maintenance, but also the costs of servicing debt and providing a fair return for equity investors.

Q. How are credit ratings assigned?

A. The rating agencies issue credit ratings for both the business entity as a whole and for the various debt issuances of the entity. For example, Moody's assigns a long-term "issuer rating" that reflects the general credit risk of the business enterprise and

Moody's opinion of the debt issuer's overall capacity to pay its scheduled financial obligations. The issuer rating is not a rating of individual securities but is the core rating of the business enterprise from which ratings of individual securities are derived. In contrast, ratings on individual debt issuances reflect the likelihood that principal and interest on those specific debt issues will be paid in a timely manner and consider the recovery prospects in the event of default. As shown below in Table MWS-3, the ratings of the two rating agencies used by ONE Gas are similar, but not identical:

Table MWS-3: Bond Ratings

Category	Moody's	S&P
High Grade	Aaa	AAA
	Aa	AA
Medium Grade	A	A
	Baa	BBB
Speculative or Non-Investment Grade	Ba	BB
	B	B
Default	Caa	CCC

The ratings are further delineated using pluses or minuses by S&P to show a company's relative standing within the categories (e.g., A- or BBB+) and through the use of numbers by Moody's (e.g., A3 or Baa1). Ratings that fall within the high-grade and medium-grade categories are generally described as being "investment grade" ratings, whereas ratings below BBB- (or Baa3 for Moody's) are sometimes described as "junk bond" ratings or "non-investment grade" ratings. In addition, each rating agency assigns an "outlook" to signal the potential direction of a rating over the intermediate term, which is typically six months to two years. A "positive" outlook indicates that the rating may be raised; a "negative" outlook indicates that the rating may be lowered; and a "stable" outlook indicates that the rating is not likely to change.

Q. How do the rating agencies evaluate the creditworthiness of issuers?

A. Each rating agency has developed criteria and methodologies that provide some transparency into the rationales for the rating agency's ratings. They assess credit worthiness by analyzing financial statements, market conditions and qualitative factors such as supportive regulatory jurisdictions. CONFIDENTIAL Exhibit MWS-1 is a report from Standard and Poor's issued just after the impact of Winter Storm Uri, explaining reasons for a downgrade and the factors it considered when establishing ratings and outlooks for regulated utilities. CONFIDENTIAL Exhibit MWS-2 is the more recent report on ONE Gas from Standard and Poor's after the Oklahoma securitization of $1.35 billion related to Winter Storm Uri was completed. CONFIDENTIAL Exhibit MWS-3 is the most recent report from Moody's which states the importance of supportive regulatory jurisdictions.

Q. What do the three reports mentioned above illustrate about the creditworthiness of a utility?

A. The three reports above, taken as a whole, give a good understanding of how important it is to have a strong capital structure and supportive regulatory jurisdictions. This is truer now than it has been in years. The country, Kansas, and ONE Gas are experiencing interest rates not seen since 2007 or in over 16 years. Capital structure and return on equity analysis must capture the financial conditions of the markets in which utilities operate.

Q. What are the primary financial ratios that credit rating agencies analyze?

A. The primary financial metrics evaluated by the major credit rating agencies include some version of the following:

1. cashflow from operations (CFO) pre-working capital to debt;
2. cashflow from operations (CFO) pre-working capital plus interest to interest;

3. cashflow from operations (CFO) pre-working capital less dividends to debt,; and
4. total debt to capitalization.

These financial metrics are a composite measure of the utility's ability to meet its financial obligations when they are due.

Q. How do investors evaluate financial stability?

A. Investors use a variety of tools, but most investors rely on company-specific credit ratings published by the major credit rating agencies (Standard & Poor's, Moody's, and Fitch Ratings ("Fitch")) as a general indication of a company's financial strength. ONE Gas uses Moody's and S&P to rate its debt. Credit ratings are assigned after the rating agencies conduct comprehensive analysis of the company and the industry and business environment in which the company operates. The regulatory framework and the company's ability to recover cost while earning a fair return account for up to 50% of their rating.

Q. Are the ratings and outlooks assigned by the rating agencies based solely on those financial ratios?

A. No. The ratings are based on a combination of quantitative and qualitative factors that the rating agencies consider important. For example, Moody's bases its ratings on the following weighted factors:

Table MWS-4: Key Rating Factors for Moody's

Factor	Weighting
Regulatory Framework	25%
Ability to Recover Costs and Earn Returns	25%
Diversification	10%
Financial Ratios	40%
Total	100%

As this table shows, the consistency and predictability of the regulatory framework and the utility's ability to recover its costs timely are collectively weighted more heavily than the financial ratios when establishing issuer ratings. Regulatory framework consists of legislative and judicial underpinnings of the regulatory framework, as well as consistency and predictability of regulations. The ability to recover costs and earn returns includes timeliness of recovery of operating and capital costs, as well as sufficiency of rates and returns. In this case, the Gas System Reliability Surcharge ("GSRS") is viewed positively; however, there are mechanisms in other states that allow for more timely recovery of all costs. Mechanisms such as the Performance Based Rate Change tariff that ONE Gas is able to utilize in Oklahoma greatly help with the company's ability to recover its investments and for changes in expenses without customers paying the costs of a full rate case each year. These are the types of mechanisms that Moody's and S&P look for in evaluating the ability to recover cost and for a strong regulatory framework. Diversification consists of market position and number of jurisdictions served. Diversification into other regulated or nonregulated businesses can actually be viewed as a negative factor as they introduce different risks than those of a natural gas distribution utility. The financial strength consists of the four key financial ratios I mentioned above. The key takeaway is that the decisions regulatory bodies make directly impact how credit rating agencies evaluate utilities.

Q. How does the utility's issuer rating affect its cost of debt?

A. When a utility issues bonds, the interest rate is based on adding a credit spread to the underlying benchmark United States Treasury bond having a similar maturity to the new bond being issued. Companies with lower credit ratings typically face wider credit spreads, which results in higher interest costs. The higher credit spreads are because these companies are deemed riskier than companies with higher credit ratings.

Companies with lower credit ratings may also find it more difficult to access capital when credit market conditions are tighter. The issuer rating of a utility impacts the rating assigned to a specific debt security.

Q. Can you give an example of when a higher credit rating has helped ONE Gas to maintain its ability to borrow debt?

A. Yes. At the start of COVID-19 in March of 2020, ONE Gas had an A rating by S&P and Moody's. If ONE Gas had been rated even one notch lower, such as (A-), it would not have been able to borrow short-term debt in the market and would have been forced to issue other forms of debt at a much higher rate. These higher cost long-term notes issued by many of ONE Gas' peers went into their costs of service and thus, cost customers more in the long run. ONE Gas, on the other hand, was able to continue to borrow in the short-term market and be opportunistic in making its next long-term debt issuance.

Q. What are ONE Gas' current issuer ratings and outlooks?

A. ONE Gas currently has an issuer rating of "A3 (Stable)" by Moody's and a rating of "A- (Stable)" by S&P. Prior to Winter Storm Uri, ONE Gas had an issuer rating of "A2 (Stable)" by Moody's and an issuer rating of "A (Stable)" by S&P. Winter Storm Uri lowered ONE Gas' credit rating one notch at Moody's to A3 (Negative) and two notches at S&P to BBB+ (Negative), immediately after the storm, with both having a negative outlook. Only by completing securitization has ONE Gas been able to get its rating increased to "A- (Stable)" by S&P and the negative removed from its "A3 (Stable)" rating by Moody's.

Q. Can you give another situation in which credit rating has made a difference?

A. Yes, in October 2023, ONE Gas decided to expand the capacity of its revolving credit agreement from $1.0 billion to $1.2 billion to ensure the liquidity it needs to meet the upcoming market conditions that some believe will result in a recession. To do this, ONE Gas went to its 10 banks and found three would not provide additional credit at this time even with ONE Gas having an "A-" rating. ONE Gas was ultimately able to expand the capacity of its revolving credit agreement; however, it does show that even with an "A-" rating credit is not always available, and this can lead to credit concerns for companies.

Q. Has ONE Gas always had the issuer ratings it has today?

A. No. Prior to the separation in 2014, the business that became ONE Gas was part of ONEOK, which was rated "BBB." This was the case during the period on and after September 11, 2001, and the financial crisis of 2008. When crises such as these happen, credit ratings matter and access to capital is the key to financial stability. In 2001 and 2008, ONEOK could not borrow in the long-term debt capital markets or short-term market and was forced to borrow directly from banks at much higher rates. During the more recent COVID-19 market scare in March/April 2020, ONE Gas had a credit rating of "A (Stable)" by S&P and "A2 (Stable)" by Moody's. During this time, ONE Gas was able to access the short- and long-term debt capital markets while many of its peers rated "BBB" did not have access.

Q. Why is it important for ONE Gas to maintain its financial stability?

A. It is vitally important for ONE Gas to maintain its financial stability to allow access to capital that enables us to prudently fund our operations and capital expenditures so we can continue to provide safe and reliable service, as well as meeting the needs of a growing customer base. We are investing capital to replace vintage pipelines (including unprotected bare steel, protected bare steel, and vintage plastic), increase resiliency, increase reliability, and expand our system to serve new customers. ONE Gas relies on a mix of operating cash flow and debt and equity to fund its operations and maintain its financial stability. This mix is essential so that we can access the financial markets regardless of the macroeconomic conditions.

Q. Can a proceeding such as this one affect ONE Gas' financial stability?

A. Yes. Achieving a balanced or constructive outcome in a rate proceeding is an important factor that is considered by the rating agencies in assessing a utility's credit quality. As noted above, 25% of Moody's rating is related to the utility's regulatory framework. Just recently S&P published an article stating that Kansas regulatory framework was below average. See CONFIDENTIAL Exhibit MWS-4 to get a better understanding of S&P's view of the Kansas' regulatory framework as compared to other states, specifically on pages 4 and 6. A further drop in the regulatory framework grade from S&P or Moody's would signal to the rating agencies, and the investors, that debt rates should rise, and the cost of equity should increase for companies doing business in Kansas.

Q. Has ONE Gas' strong balance sheet benefited the Company and its customers in different situations?

A. Yes, I can think of two recent situations in which ONE Gas' strong balance sheet has benefited the Company, and ultimately its customers. The first would be related to Winter Storm Uri and the second would be related to the tax law changes that took place in December 2017.

During Winter Storm Uri, ONE Gas was faced with a liquidity crisis related to gas costs. On Thursday, February 11, 2021, KGS's Gas Supply department began to see natural gas prices spike as KGS Operations was preparing for the severe weather, and what turned out to be, a sustained winter storm affecting all three states in which ONE Gas operates. ONE Gas was faced with several gas supply issues: high customer demand; the inability of gas suppliers to deliver gas; and spiking commodity prices. The significant increase in the price for the daily gas purchases on Friday, February 12, coincided with a holiday weekend, which required the Company to procure gas on Friday, February 12 for a four-day period (Saturday, Sunday, Monday, and Tuesday), because Monday, February 15, was Presidents' Day and the financial markets and banks were closed in observance of the national holiday. ONE Gas needed to access additional cash, or liquidity, to provide adequate assurance to gas suppliers and pay for gas purchases when those payments were due (generally on or around March 25, 2021) to have enough supply to serve its customers. If ONE Gas or KGS could not have provided adequate assurance, suppliers would have refused to sell gas to the Company and KGS would have been without sufficient gas supplies for its customers. Soon after the settlement prices were fixed for the commodity purchases made on Friday, February 12, ONE Gas determined it did not have enough liquidity to pay for the gas it had procured to meet the needs of its customers.

ONE Gas had to delay the filing of its annual Form 10-K due to the winter storm event and the fact that ONE Gas did not have sufficient liquidity under its existing liquidity sources to pay for the associated gas it was purchasing for its customers. In connection with preparing financial statements, ONE Gas management had to evaluate the entity's ability to continue as a going concern based on conditions and events that are relevant to its ability to meet its obligations as they become due within one year after the date that the financial statements are issued (based on ASC Topic 205-40-50). Because of the gas purchase costs and lack of liquidity to meet these payment obligations, management could not represent to the auditors that it would be able to continue as a going concern. If ONE Gas is unable to determine it has the ability to continue as a going concern, its auditors would be required to issue an opinion on the financial statements that there is substantial doubt as to the entity's ability to continue as a going concern, which would not be an unqualified or "clean" audit opinion. The inability to file audited financials with a clean audit opinion would be a default under ONE Gas' credit facilities and would have triggered a cross-acceleration clause on all of ONE Gas' existing debt. This result would have effectively made all of ONE Gas' debt due and payable upon demand and would have effectively prevented ONE Gas from accessing the public capital markets. After ONE Gas put a term loan in place and issued a Form 8-K explaining the potential exposure to ONE Gas resulting from the extraordinary storm related commodity costs, S&P downgraded ONE Gas' debt rating by two notches to "BBB+ (Negative)" and Moody's downgraded its debt rating by one notch to "A3 (Negative)." These lower debt ratings would result in all the future debt issued by ONE Gas to be at a higher rate, including the bonds that were issued to replace the term loan. Once these bonds were issued in March 2021, ONE Gas' outstanding long-term debt increased to $4.1 billion from $1.6 billion. If ONE Gas had not had such a strong balance sheet with such a high equity percentage (59.2% at the time or just prior to the event), the impact would have been disastrous for the Company. In fact, the Company could have found it impossible to issue debt and could have resulted in technical defaults on the Company's other debt.

Q. Please explain the second situation during which a strong balance sheet was a benefit.

A. The second situation relates to changes to the federal tax law in December 2017, which caused Moody's to change the outlook on 25 U.S. regulated utilities. CONFIDENTIAL Exhibit MWS-5 is the article that Moody's released on January 19, 2018, changing the outlook on 25 regulated utilities. While the exhibits I am about to quote from should be considered confidential, ONE Gas secured Moody's permission to provide the following quotations in public testimony. Moody's stated:

> Tax reform is credit negative for US regulated utilities because the lower 21% statutory tax rate reduces cash collected from customers, while the loss of bonus depreciation reduces tax deferrals, all else being equal. Moody's calculates that the recent changes in tax laws will dilute a utility's ratio of cash flow before changes in working capital to debt by approximately 150 - 250 basis points on average, depending to some degree on the size of the company's capital expenditure programs. From a leverage perspective, Moody's estimates that debt to total capitalization ratios will increase, based on the lower value of deferred tax liabilities.

In a follow up article (CONFIDENTIAL Exhibit MWS-6), Moody's stated:

> In practice, we believe that most companies will actively manage their cash flow to debt ratios by issuing more equity or obtaining relief by working through regulatory channels. For example, to offset a decline in cash flow, utilities could propose to regulators additional investments that benefit customers or accelerate recovery of regulatory assets. Some of the corporate measures could have a more immediate boost to projected metrics than certain regulatory provisions, which may take time to approve and implement. They could also propose to increase the equity layer in rates or the level of the authorized return on equity. In these cases, a cooperative regulatory relationship matters most for a given utility.

One year later, in January 2019, Moody's moved ONE Gas back to stable from negative, in large part because ONE Gas was able to maintain metrics that supported the rating, **without** issuing any equity. In fact, ONE Gas did not issue equity from 2014 until 2020, at which time it only issued $13.6 million in equity. It was ONE Gas' strong capital structure, including an equity component around the 60% range, and supportive regulatory construct that convinced Moody's to maintain ONE Gas' "A2, (Stable)" rating. When reaffirming ONE Gas' rating, Moody's stated the following:

> **Rating outlook**
> ONE Gas' stable rating outlook is predicated on the utility's ability to keep generating consistent and predictable operating cash flows; the continued supportiveness of its three state regulators; conservative financing policies; and the maintenance of relatively weak but sustained debt coverage ratios, including CFO pre-WC to debt around 20%.

See CONFIDENTIAL Exhibit MWS-7.

In short, a strong balance sheet and strong debt rating can benefit a company in times of change, whether it be tax reform, the COVID-19 pandemic, or Winter Storm Uri.

Q. Did Moody's or S&P voice any concerns about the COVID-19 pandemic and its impact on utilities?

A. Yes, in an article released March 19, 2020, by S&P titled, "North American Regulated Utilities Face Additional Risks Amid Coronavirus Outbreak", S&P stated:

> We believe that the majority of North American regulated utilities are well positioned to handle the immediate impact of COVID-19. However, the pandemic could negatively affect a few outliers and those issuers already facing downside ratings pressure prior to the arrival of the coronavirus. Some electric utilities with disproportionate exposure to commercial and industrial class of customers could be vulnerable to reduced sales volumes, absent any regulatory counter mechanisms such as decoupling. Utilities with cyclical non-utility businesses could suffer downturns in the cycle. Utilities with strict construction schedules related to large-scale projects may find it difficult to meet tight deadlines. A sustained COVID-19 pandemic may constrain some utilities' ability to execute on planned equity issuance or weaken access to the capital markets.

See CONFIDENTIAL Exhibit MWS-8. Later, on April 2, 2020, S&P revised its assessment of the North American utility industry downward from stable to negative noting:

> For the North America utility industry, we expect that COVID-19 will reduce the commercial and industrial (C&I) usage (North American Regulated Utilities Face Additional Risks Amid Coronavirus Outbreak, March 19, 2020). While some utilities will be able to offset some of the lower C&I usage through various regulatory mechanisms that include decoupling of revenues mechanisms and formula rates, many others will see a weakening of sales. Furthermore, as the recession continues to take hold, we expect bad debt expense will increase as it becomes increasingly more difficult for customers to pay their bills.

See CONFIDENTIAL Exhibit MWS-9.

These comments from Moody's and S&P further support the need for a utility to maintain both a strong balance sheet and credit rating.

Q. Did Moody's or S&P voice any concerns about the impact of Winter Storm Uri?

A. Yes, in a news article dated February 26, 2021, titled "Historic winter weather left gas utilities with financial troubles," S&P issued several rating downgrades after the utilities' reported earnings and potential exposures. Additionally, they flagged others for higher financial risk and listed some of the downgraded companies for further potential downgrades. On March 8, 2021, in an article titled "Gas utilities 'most severely affected' by winter storm prices," Moody's was quoted as saying:

> The extent of the frigid weather's impact will vary widely depending on each company's exposure to natural gas operations, their use of commodity risk mitigation tools, their management of customer and regulatory relations, the timeliness of cost recovery as well as available liquidity, ownership structure and the diversity of the group's operations.

Q. With the COVID-19 pandemic arguably behind us and Winter Storm Uri taking place in 2021, why do those events remain relevant to the Commission's decision in this case?

A. In addition to them being recent examples of how quickly financial markets can be impacted by unforeseen events that are outside of anyone's direct control, the economic fallout from both of those events continues to impact financial markets and the Company. A good example of this is that as recently as October 2023 some banks were strained and were not able to extend additional capital to us as we upsized our revolving credit agreement. Thus, many different world and economic events can lead to changes that make borrowing more difficult.

Q. What would ONE Gas' experience during the Federal tax law change, the COVID-19 pandemic, or Winter Storm Uri have been if its capital structure was 50% debt and 50% equity?

A. Most likely ONE Gas would have been issuing debt at a much higher rate and those rates would still be outstanding with customers continuing to pay for those higher rates today. Additionally, during these times of crisis, the Company would have had to rely on its banks for liquidity at much higher rates. The other thing to note is that several banks did not have the capital to lend during these events and were strained to lend money thereby limiting them as a source. This would have further pushed up the price that ONE Gas and KGS's customers would have had to pay, both during the event and even after the event.

Q. How do decisions regarding the Company's authorized cost of debt, capital structure, and ROE affect ONE Gas' financial stability?

A. Decisions regarding these key financial factors affect ONE Gas' financial strength in several ways, including:

- The Company's authorized ROE and equity ratio directly affect ONE Gas' earnings and its ability to fund the Company's capital investment with internally generated funds. Both debt and equity investors expect a utility to be able to internally generate a substantial portion of its investment funding.
- The capital structure and authorized returns directly affect ONE Gas' key credit metrics because either total debt or interest expense is a component of each of the primary credit metrics that rating agencies analyze.
- Bond and equity investors expect ONE Gas to be able to recover its actual cost of service in a timely manner, to be able to recover its actual cost of capital through use of its actual capital structure and debt costs and to have an opportunity to earn its authorized ROE. As I will explain later in my testimony, investors, and credit rating agencies' perceptions regarding the regulatory environment in which a utility operates are an important consideration in assessing the utility's risk.

Q. Are you aware of any other facts that support the Company's requested capital structure?

A. Yes, in the first quarter of 2022, ONE Gas issued an additional $35 million in equity, thereby pushing the equity component of its capital structure to above 61%. Additionally, on December 28, 2023, One Gas issued an additional $79 million in equity to keep the Company's equity at a level consistent with its rating. In a proactive move during 2023, ONE Gas also issued $272 million of equity through forward transactions that will settle the end of 2024. Therefore, the Company's requested equity component of 59.58% is appropriate.

V. <u>Section 7 of the Commission's Minimum Filing Requirements</u>

Q. Are you supporting Section 7 of this filing?

A. Yes, I am supporting Section 7 of the Commission's Minimum Filing Requirements, with my testimony and schedules supporting a capital structure of 40.42% debt and a capital structure of 59.58% equity. I have used the 10.25% ROE that Company Witness Dr. Bruce Fairchild is supporting and the 4.40% rate on long-term debt that is calculated on 7-B. Schedule 7-A supports a weighted cost of capital of 7.8849%.

VI. <u>The Company's Requested Return on Equity</u>

Q. Do you agree with the equity return that Dr. Fairchild is proposing in his testimony?

A. Yes, I agree with using a rate towards the higher end of the range based on the changes we are seeing in the market, the relative size of ONE Gas compared to its peers in the market, the ROEs received by its peers, the increasing risk utilities are being exposed to, and based on discussions held with equity investors and equity analysts. It is now relatively common knowledge that interest rates have gone up significantly to combat higher inflation in the U.S., which included inflation rates as high as 8.6%, a rate not seen in the past 40 years. While inflation is starting to come down, no one can predict when inflation will return to the levels seen when the Commission last evaluated KGS's base rates. Therefore, it is important to recognize this reality and how it impacts return on equity analysis so that ONE Gas' credit metrics are maintained in a more challenging environment. Complicating the way ONE Gas navigates this environment, I will demonstrate that the way KGS recovers its cost of service from customers never allows the Company to earn its authorized rate of return. To be sure, KGS is not advocating it must recover its authorized rate of return. The standards set forth in federal and state Supreme Court decisions make clear utilities must only have an opportunity to earn their fair return. My analysis shows that for every year since KGS last filed a rate case, KGS never earned its authorized rate of return. The fact that the Company <u>never</u> earned its authorized rate of return strongly indicates KGS never had a reasonable opportunity to earn its return.

Q. How has the market impacted the cost of equity and the need for a higher ROE?

A. Higher interest rates have increased the cost of equity for everyone, including utilities, by decreasing the per share value of equity. As the U.S. Treasury rates have risen, utility stocks have become less attractive. Investors can now invest in a tax-free bond that has up to double the yield of a utility stock. Even when you consider the growth factor of the utility stock, the risk-free U.S. Treasury is more attractive. To be able to compete with this reality higher ROEs and better recovery mechanisms are necessary.

Q. How have higher interest rates impacted utilities' and ONE Gas' cost of equity?

A. Higher interest rates can impact utilities' cost of equity in several ways. When interest rates rise, the cost of debt for utilities also increases. This can lead to higher interest expenses and potentially impact the overall financial health of the utility. As a result, investors may perceive utilities as riskier investments, and this can lead to an increase in the cost of equity.

Additionally, higher interest rates can impact the discount rate used in determining the cost of equity. The discount rate is used to calculate the present value of future cash flows, and it is often based on the risk-free rate plus a risk premium. When interest rates rise, the risk-free rate also increases, leading to a higher discount rate.

As a result, the cost of equity for utilities can increase, as investors will require a higher return to compensate for the increased risk associated with the higher discount rate. Furthermore, higher interest rates can impact the overall economic environment, potentially leading to lower economic growth and reduced consumer spending. This can impact the revenue and earnings growth potential of utilities, which in turn can impact investors' perception of the utility's risk and return potential.

In summary, higher interest rates can lead to an increase in the cost of equity for utilities due to higher borrowing costs, increased discount rates, and potential impacts on the overall economic environment. An equity investor's return is residual, meaning that equity investors receive their return after the bond investors.

Q. Does a utility's credit rating also affect its cost of equity?

A. Yes. An equity investor's return is residual, meaning that equity investors receive their return after the bond investors. A lower credit rating results in greater risk to both the bond and equity investors, and those investors also require higher returns to be compensated for the additional risk. Additionally, the treasury rates (a benchmark for the risk-free rate) have increased significantly and the equity values of utilities have dropped making equity more costly and therefore justifying a higher increase in the ROE that utilities earn. The table below (Table MWS-5) shows a 15 to 19% increase in the five-, ten-, and thirty-year treasury rates for the 9 months ended September 30, 2023, and a 4 percent decrease to a 1 percent increase in the five-, ten-, and thirty-year treasury rates for the 12-month period ended December 31, 2023. While the corresponding decrease in utility stock prices over the same periods was 16 for the 9 months ended September 30, 2023, and a decrease of 9% for the 12 month period ended December 31, 2023.~~the increases in the five-, ten-, and thirty-year treasury rates and the corresponding decrease in utility stock prices over the same periods.~~

Table MWS-5: Increase in Interest Rates Compared to Decrease in Stock Prices

	Value on December 31, 2022	Value on December 31, 2023	Increase / (Decrease)	Percentage Increase / (Decrease)	Value on September 30, 2023	Increase / (Decrease)	Percentage Increase / (Decrease)
5-Year U.S. Treasury	4.00%	3.84%	-0.16%	-4.00%	4.61%	0.61%	15.15%
10-Year U.S. Treasury	3.88%	3.87%	-0.01%	-0.34%	4.57%	0.69%	17.89%
30-Year U.S. Treasury	3.98%	4.02%	0.04%	1.11%	4.71%	0.74%	18.52%
Dow Jones Utility Average	$967.40	$881.67	($85.73)	-8.86%	$816.55	($150.85)	-15.59%
ONE Gas, Inc.	$75.72	$63.72	($12.00)	-15.85%	$68.28	($7.44)	-9.83%
Atmos Energy Corporation	$112.07	$115.90	$3.83	3.42%	$105.93	($6.14)	-5.48%
Evergy, Inc.	$62.93	$52.20	($10.73)	-17.05%	$50.70	($12.23)	-19.43%
Black Hills Corporation	$70.34	$53.95	($16.39)	-23.30%	$50.59	($19.75)	-28.08%

Source: Yahoo Finance

	Value on December 31, 2022	Value on December 31, 2023	Increase/(Decrease)	Percent Increase /(Decrease)
5-Year U.S. Treasury	4.00%	4.61%	0.61%	15.15%
10-Year U.S. Treasury	3.88%	4.57%	0.69%	17.89%
30-Year U.S. Treasury	3.98%	4.71%	0.74%	18.52%
Dow Jones Utility Average	$967.40	$816.55	($150.85)	-15.59%
ONE Gas, Inc.	$75.72	$68.28	($7.44)	-9.83%
Atmos Energy Corporation	$112.07	$115.90	$3.83	3.42%
Evergy, Inc.	$62.93	$52.20	($10.73)	-17.05%
Black Hills Corporation	$70.34	$54.31	($16.03)	-22.79%

Source: Yahoo Finance

	Value on December 31, 2022	Value on December 31, 2023	Increase / (Decrease)	Percentage Increase / (Decrease)	Value on September 30, 2023	Increase / (Decrease)	Percentage Increase / (Decrease)
5-Year U.S. Treasury	4.00%	3.84%	-0.16%	-4.00%	4.61%	0.61%	15.15%
10-Year U.S. Treasury	3.88%	3.87%	-0.01%	-0.34%	4.57%	0.69%	17.89%
30-Year U.S. Treasury	3.98%	4.02%	0.04%	1.11%	4.71%	0.74%	18.52%
Dow Jones Utility Average	$967.40	$881.67	($85.73)	-8.86%	$816.55	($150.85)	-15.59%
ONE Gas, Inc.	$75.72	$63.72	($12.00)	-15.85%	$68.28	($7.44)	-9.83%
Atmos Energy Corporation	$112.07	$115.90	$3.83	3.42%	$105.93	($6.14)	-5.48%
Evergy, Inc.	$62.93	$52.20	($10.73)	-17.05%	$50.70	($12.23)	-19.43%
Black Hills Corporation	$70.34	$53.95	($16.39)	-23.30%	$50.59	($19.75)	-28.08%

Source: Yahoo Finance

This table shows that treasury rates have gone up or stayed flat on average ~~17 percent~~, while the stock price for utilities has gone down on average ~~12 percent~~. I would note that Atmos' stock went up in 2023 due to the overhang relating to their $2.5 billion Texas Securitization being completed.

Q. What does this tell you about the cost of equity and utilities' ROEs?

A. This is showing that investors now have more options and in fact they are now viewing Treasuries as a more attractive option versus utility stocks. This means that utilities are not earning enough on their equity to justify investing in them over the risk-free rate of Treasuries.

Q. You have shown that the utility stocks decreased in general last year, however, how did they compare to the broader market?

A. Like the comparison to U.S. Treasuries, utility stocks did not fare well when compared to the general market. The table below (Table MWS-6) shows that the Dow Jones Utility Average, as well as the major utilities in Kansas have underperformed the general market, once again making the cost of equity for utilities more expensive.

Table MWS-6: Utility Stocks Compared to the Broader Market for Last Year

	Value on December 31, 2022	Value on December 31, 2023	Increase/(Decrease)	Percent Increase /(Decrease)
S&P Mid Cap 400 Index	$2,430.38	$2,781.54	$351.16	14.45%
Russel 3000	$2,217.14	$2,748.21	$531.07	23.95%
Dow Jones Utility Average	$967.40	$816.55	($150.85)	-15.59%
ONE Gas, Inc.	$75.72	$68.28	($7.44)	-9.83%
Atmos Energy Corporation	$112.07	$115.90	$3.83	3.42%
Evergy, Inc.	$62.93	$52.20	($10.73)	-17.05%
Black Hills Corporation	$70.34	$54.31	($16.03)	-22.79%

Source: Yahoo Finance

	Value on December 31, 2022	Value on December 31, 2023	Increase / (Decrease)	Percentage Increase / (Decrease)	Value on September 30, 2023	Increase / (Decrease)	Percentage Increase / (Decrease)
S&P Mid Cap 400 Index	$2,430.38	$2,781.54	$351.16	14.45%	$2,502.12	$71.74	2.95%
Russel 3000	$2,217.14	$2,748.21	$531.07	23.95%	$2,462.06	$244.92	11.05%
Dow Jones Utility Average	$967.40	$881.67	($85.73)	-8.86%	$816.55	($150.85)	-15.59%
ONE Gas, Inc.	$75.72	$63.72	($12.00)	-15.85%	$68.28	($7.44)	-9.83%
Atmos Energy Corporation	$112.07	$115.90	$3.83	3.42%	$105.93	($6.14)	-5.48%
Evergy, Inc.	$62.93	$52.20	($10.73)	-17.05%	$50.70	($12.23)	-19.43%
Black Hills Corporation	$70.34	$53.95	($16.39)	-23.30%	$50.59	($19.75)	-28.08%

Source: Yahoo Finance

This table shows that the market has increased in general~~ 14% to 24%~~, while utilities decrease ~~an~~ on average~~ 12%~~.

Q. Does the size of a utility impact its cost of capital?

A. Yes. A utility with a smaller market capitalization should have a higher return on equity for several reasons. First, smaller utilities often have limited access to capital and may face higher borrowing costs compared to larger utilities. While KGS is Kansas' largest natural gas public utility, it is relatively small compared to other public companies. In order to attract investors and raise capital, a smaller utility may need to offer a higher return on equity to compensate for the higher risk associated with their smaller size and potentially less diversified operations.

Additionally, smaller utilities may have limited economies of scale and may not benefit from the same cost efficiencies as larger utilities. As a result, they may need to generate higher returns on equity to remain competitive and attract investment in order to fund necessary infrastructure upgrades and improvements.

Moreover, smaller utilities may face greater operational and regulatory risks, particularly if they operate in a limited geographic area. These risks can impact the stability and predictability of their earnings, necessitating a higher return on equity to compensate investors for the higher level of uncertainty.

Overall, a smaller market capitalization puts a utility at a competitive disadvantage, and a higher return on equity can help offset these challenges and attract the necessary investment to support the utility's operations and growth.

Another factor driving this issue is the larger the company the more the stock trades and the more daily float it has in the market. This is directly related to the fact that more shares are owned by more people and these shares are trading more often than stocks with a lower capital structure. Small cap, mid cap and large cap definitions can vary; however, small cap is usually defined as having a market cap of under $5 billion, and mid cap is usually defined as having a market cap of $5 billion to $15 billion, and large cap is usually defined as have a market cap of over $15 billion.

Q. What is ONE Gas' current market capital and how does it compare to its peers?

A. The current market cap of ONE Gas is $3.5 billion which puts it at the middle to higher end of the small cap space. Table MWS-7 below has the market cap of ONE Gas compared to the other large utilities in the state of Kansas.

Table MWS-7: ONE Gas Market Cap Compared to Kansas Peers

Kansas Peer Group	Share Price at 12/31/23	Shares Outstanding	Market Cap
Atmos Energy Corporation	$115.90	148,462,481	$17,206,801,548
Evergy, Inc.	$52.20	229,720,757	$11,991,423,515
Black Hills Corporation	$53.95	67,991,643	$3,668,149,140
ONE Gas, Inc.	$63.72	55,454,050	$3,533,532,066

Table MWS-7 shows that it has the smallest market cap of the major utilities in Kansas. Table MWS-8 below shows the market cap of ONE Gas compared to the peers it uses for its Proxy and for its long-term incentives. While many of these firms are larger and can have electric utilities or non-regulated business, they are the closest match to ONE Gas.

Table MWS-8: ONE Gas Market Cap Compared to its Peers

ONE Gas Peer Group	Share Price at 12/31/23	Shares Outstanding	Market Cap
CenterPoint Energy, Inc.	$28.57	631,223,560	$18,034,057,109
Atmos Energy Corporation	$115.90	148,462,481	$17,206,801,548
CMS Energy Corporation	$58.07	291,763,567	$16,942,710,336
Alliant Energy Corporation	$51.30	255,179,087	$13,090,687,163
NiSource Inc.	$26.55	413,415,441	$10,976,179,959
Southwest Gas Holdings, Inc.	$63.35	71,519,025	$4,530,730,234
New Jersey Resources Corporation	$44.58	97,707,564	$4,355,803,203
Black Hills Corporation	$53.95	67,991,643	$3,668,149,140
ONE Gas, Inc.	$63.72	55,454,050	$3,533,532,066
Spire Inc.	$62.34	53,176,840	$3,315,044,206
NorthWestern Energy Group, Inc.	$50.89	61,242,238	$3,116,617,492
Avista Corporation	$35.74	77,367,612	$2,765,118,453
Chesapeake Utilities Corporation	$105.63	17,796,741	$1,879,869,752
Northwest Natural Holding Company	$38.94	36,778,271	$1,432,145,873

Q. What do tables MWS-7 and MWS-8 indicate about ONE Gas cost of capital?

A. They indicate that ONE Gas should be earning a higher ROE than many of its peers and should also be earning more in Kansas because of its size relative to the other utilities in the state.

Q. Have you looked at the ROE of your peers in Kansas and your broader peer group?

A. Yes, I have. In doing this I pulled the various company’s investor presentations, and I determined that a higher ROE is justified for ONE Gas. Table MWS-9 shows that ONE Gas’ ROE is low compared to its peers. This table is shown on the following page. The remainder of this page is intentionally left blank.

Table MWS-9: ROE of ONE Gas' Peer Groups

ONE Gas's Peer ROEs

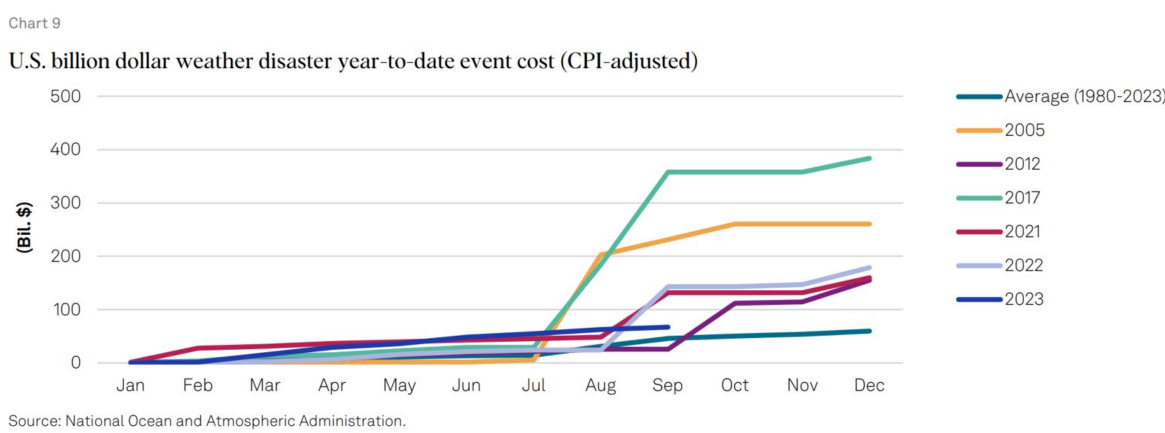
Alliant Energy		**Avista Corporation**	
Iowa Retail (IUB):	9.60%	Washington	9.40%
Wisconsin Retail (PSCW):	10.00%	Idaho	9.40%
Atmos Energy		Oregon	9.40%
Colorado	9.45%	Alaska	11.95%
Kansas	9.40%	**CMS Energy**	
Kentucky	9.23%	Michigan	9.90%
Tennessee	9.80%	**NiSource**	
Virginia	9.20%	Ohio	9.60%
Lousiana	9.80%	Pennsylvania	
Mid-Tex Cities	9.80%	Massachusetts	9.55%
Dallas	9.80%	Virginia	9.70%
Mississippi	10.24%	Kentucky	9.35%
West Texas	9.80%	Maryland	9.65%
Blackhills Corporation		NIPSCO - Gas	9.85%
Arkansas Gas	9.61%	**Spire Energy**	
Colorado Gas	9.20%	Alabama	9.70%
Colorado Gas Dist.	10.00%	Gulf	9.95%
Rocky Mountain Natural Gas	9.90%	Mississippi	9.83%
Iowa	9.60%	Missouri	9.37%
Nebraska Gas Dist.	9.60%	**Southwest Gas**	
Wyoming Gas	9.40%	Arizona	9.30%
New Jersey Resources		California[1]	10.00%
New Jersey	9.60%	Nevada[2]	9.40%
Northwest Natural		South Lake Tahoe	10.10%
Oregon	9.40%	Paiute Pipeline Company	11.80%
Washington	9.40%		
		Minimum	9.20%
		Max	11.95%

These results show that the ROE of 10.25% presented by Dr. Bruce Fairchild is reasonable.

Q. Are utilities continuing to see more risk associated with their business?

A. Yes, and this risk is requiring a higher equity premium in the market. Utilities' exposure to physical risks continues to increase. Whether it is wildfire exposure or weather related, the risk has increased and is expected to continue. According to the National Oceanic and Atmospheric Administration (NOAA), on an inflation-adjusted basis, 2021 and 2022 represent two of the top five most destructive years for extreme weather events since 1980 (see Table MWS-10). These trends are expected to persist, magnifying physical risks for the utility industry.

Table MWS-10: Dollar Cost of Weather-Related Disasters



In addition to these weather events, litigation risk, securitization risk, and capital spending leads to the need to increase the ROE. Because utilities operate under potentially hazardous conditions that include safety as well as environmental risks, they have always been susceptible to litigation. On the litigation front, nine utilities have been sued on wildfire issues and several class action lawsuits have been filed against water utilities. If this type of litigation continues it will affect credit quality and require higher ROEs. The cost of these storms, weather events, and litigation have led utilities to use securitization which may further increase the risk of a utility to make a profit without a supportive regulatory environment. The spending being undertaken by utilities is all done in an effort to bring the systems up to date so that the utility is providing safe and reliable service. Electric utilities are also faced with energy transition and renewable energy issues causing additional risk to the utility space.

Q. What do you see as an even bigger issue that may drive the need for higher ROEs?

A. The number one issue for utilities is higher inflation and higher interest rates. While inflation has come down from its peak in the 8% range, it remains elevated compared to historical levels and to the policy target of the Federal Reserve. This higher level of inflation will exaggerate the effect of regulatory lag as most utilities do not have mechanisms to reduce this lag and will result in companies filing more frequent rate cases. According to S&P, the average annual rate cases in 2019 and 2020 averaged $6 billion for the year; however, they have increased 2.5 times to an annual average of about $16 billion. Much of this is led by the higher long-term debt rates and the recovery of higher costs associated with inflation on costs such as labor, contractors, medical and other costs, as well as the impact that inflation is having on capital expenditures.[1]

Q. Do you have the opportunity to communicate with the investment community and credit rating agencies as Vice President and Treasurer for ONE Gas?

A. Yes, my duties include communicating with the investment community and credit ratings agencies on a regular basis. I am also involved in preparing communications

[1] S&P Global Ratings; Industry Credit Outlook 2024; North America Regulated Utilities: Credit quality remains pressured; published January 9, 2024.

such as the Company's annual report, proxy, filings with the Securities and Exchange Commission, and investor presentations.

Q. Based on your experience, do you have any opinions about the current environment relevant to ONE Gas?

A. I do. As Dr. Fairchild's testimony describes, utilities are currently facing challenging investment and credit environments, and those environments are expected to get more challenging in the near future. For those reasons, the Commission's decisions on equity return and capital structure are important in this case both for ONE Gas and its customers. In particular, as debt costs increase, it will be important for ONE Gas to maintain its credit quality so that it can continue to borrow at the lowest costs possible.

Q. Have you had discussion with investors and analysts on their view of the ROEs that the Company is being granted and achieving?

A. Yes, as recently as December 2023, I attended several investor and analyst meetings and was able to ask about their view on ROEs and concerns they had about the earned ROE as compared to the authorized ROE.

Q. From the meetings in December 2023, can you describe the investor sentiment surrounding ROE and recovery of costs?

A. Yes. I made a point to note how investors were examining the regulatory environment for natural gas companies. Investors are searching to invest in companies that can: (1) recover their costs in a timely manner, and (2) have an opportunity to earn a fair rate of return. Regulatory commissions that adopt mechanisms to improve the timeliness of recovery and reduce regulatory lag will better allow the utility to attract capital at a reasonable cost. An ROE which is consistent with or above the average of nationwide ROEs or the levels other regulatory jurisdictions are issuing would allow ONE Gas to attract capital investment on more reasonable terms.

Q. Can KGS actually earn its ROE?

A. No, it cannot. Even with the GSRS, the Company will not be able to earn its allowed ROE. Additionally, inflation on cost will also eat into this amount.

Q. You mention that even with the GSRS mechanism the Company is precluded from earning its allowed ROE. Can you show how that actually impacted KGS since their last rate case?

A. Yes, I can. Since its 2018 rate case (Docket No. 18-KGSG-560-RTS), KGS's lost return related to capital spending is \$51.3 million and the lost depreciation expense is \$78.5 million for a total of \$129.9 million. During this time, the GSRS generated revenue of \$65.3 million, which created an ultimate under earnings of \$64.6 million. This can be seen in Table MWS-12 below:

Table MWS-12: Impact of Regulatory Lag

	2019	2020	2021	2022	2023	Total
Lost Return	\$2,869,284	\$6,245,260	\$9,365,729	\$13,569,277	\$19,289,806	\$51,339,355
Lost Depreciation	\$9,998,102	\$13,233,828	\$15,967,320	\$18,284,434	\$21,057,008	\$78,540,692
Total loss	\$12,867,386	\$19,479,087	\$25,333,048	\$31,853,712	\$40,346,814	\$129,880,047
Less: GSRS	\$352,699	\$4,857,415	\$12,369,055	\$20,008,416	\$27,710,821	\$65,298,405
Net Loss	\$12,514,687	\$14,621,672	\$12,963,994	\$11,845,296	\$12,635,994	\$64,581,642

Q. Can you demonstrate the impact this has on earned ROE?

A. Yes. Table MWS-13 below shows the loss compared to rate base and then goes on to show the actual impact to ROE based on the actual capital structure.

Table MWS-13: Impact of Lag on ROE

($000s)	2019	2020	2021	2022	2023	Annual Average
Rate base	**$1,030,165**	**$1,122,739**	**$1,245,647**	**$1,241,622**	**$1,341,893**	
Loss	**$12,515**	**$14,622**	**$12,964**	**$11,845**	**$12,636**	
Rate of Return impact (net of GSRS)	**1.21%**	**1.30%**	**1.04%**	**0.95%**	**0.94%**	**1.09%**
Equity funding	62.35%	58.53%	59.74%	57.90%	59.58%	
Return on Equity impact	**1.95%**	**2.23%**	**1.74%**	**1.65%**	**1.58%**	**1.83%**

This shows that on average annual basis KGS's ROE will be 1.83% lower than the level authorized by the Commission. Therefore, for the Commission to provide KGS an opportunity to earn its allowed rate of return the ROE would need to be set 1.83% higher than the rate intended.

Q. Your analysis refers to "Allowed ROE." How did you calculate that?

A. KGS's last base rate case resulted in a settlement that did not contain a stated ROE. However, like the Atmos settlement I discussed before, Staff analyzed pre-tax Rates of Return depending on ROE and capital structure. A 9.3% allowed ROE aligns with Staff's position.

Q. Wouldn't your analysis be the same no matter what ROE the Commission authorizes?

A. It would. I wanted to provide this analysis to detail how the operation of a utility, particularly in this challenging financial environment, naturally inhibits its ability to earn its authorized return. Recognizing this, KGS's request for 10.25% Return on Equity takes the first step of giving KGS the opportunity to earn a fair rate of return commensurate with the risks experienced by similarly situated companies.

Q. What is considered "a reasonable return" can vary over time. How would KGS address changes in financial markets as they impact customers?

A. As described by Company Witness Mr. Sean Postlethwait, KGS has undertaken a significant obsolete infrastructure replacement program. The Commission has recognized the need to replace obsolete infrastructure and directed natural gas companies to develop infrastructure replacement plans. KGS utilizes Kansas' GSRS mechanism to adjust rates for the investment related to its pipeline replacement programs and other safety-related investments and requires the Company to file rate cases every five to six years. For that reason, KGS will continue to appear before the Commission at a regular cadence. Regardless of how financial markets adjust, KGS will continually appear before the Commission and adjustments implemented. Moreover, if the Commission adopts the performance-based rate mechanism described by Company Witness Ms. Janet Buchanan, KGS will undertake base rate cases every five years.

Q. You have discussed ROE from a lot of different directions. Can you summarize your thoughts on KGS's allowed ROE?

A. Yes. The following points summarize the discussion I provide on ROE:

- KGS's current ROE is significantly below the market;
- the risk-free treasury rates have significantly increased causing both the debt and equity costs to increase;
- utilities are faced with more risk than they have had in the past and it is clear that investors have been taking this into account;
- KGS does not currently have regulatory mechanisms in place that provide the utility with a reasonable opportunity to earn its allowed ROE; and,
- KGS has not actually had a reasonable opportunity to earn its allowed ROE.

Additionally, the fall in utility stock prices compared to interest rates makes it clear that the cost of capital is now higher. With that, I am fully supporting Dr. Fairchild's recommended 10.25% ROE.

Q. Does this conclude your testimony?

A. Yes, it does.

VERIFICATION

STATE OF OKLAHOMA)
) ss.
COUNTY OF TULSA)

Mark W. Smith, being duly sworn upon his oath, deposes and states that he is the Vice President and Treasurer for ONE Gas, Inc.; that he has read and is familiar with the foregoing Direct Testimony filed herewith; and that the statements made therein are true to the best of his knowledge, information, and belief.

Mark W. Smith

Mark W. Smith

Subscribed and sworn to before me this 16 day of April 2024.

Kathleen Hill

NOTARY PUBLIC

KATHLEEN HILL
NOTARY
14000359
EXP. 01/13/26
PUBLIC
STATE OF OKLAHOMA

My appointment Expires:
01/13/26

<u>**CERTIFICATE OF SERVICE**</u>

I, <u>Robert Elliott Vincent</u>, hereby certify that a copy of the above and foregoing *Amended Direct Testimony of Mark W. Smith* was forwarded this 22nd day of April 2024, addressed to:

JAMES G. FLAHERTY, ATTORNEY
ANDERSON & BYRD, L.L.P.
216 S HICKORY
PO BOX 17
OTTAWA, KS 66067
jflaherty@andersonbyrd.com

JEFF AUSTIN
AUSTIN LAW P.A.
7111 W. 151st ST.
SUITE 315
OVERLAND PARK, KS 66223
jeff@austinlawpa.com

JOSEPH R. ASTRAB, ATTORNEY
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
j.astrab@curb.kansas.gov

TODD E. LOVE, ATTORNEY
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
t.love@curb.kansas.gov

DAVID W. NICKEL, CONSUMER COUNSEL
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
D.NICKEL@CURB.KANSAS.GOV

SHONDA RABB
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
s.rabb@curb.kansas.gov

DELLA SMITH
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
d.smith@curb.kansas.gov

ALEX GOLDBERG, ATTORNEY
EVERSHEDS SUTHERLAND (US) LLP
1196 S MONROE STREET
DENVER, CO 80210
alexgoldberg@eversheds-sutherland.us

ABIGAIL EMERY, PARALEGAL & GRANT SPECIALIST
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
a.emery@kcc.ks.gov

BRIAN G. FEDOTIN, GENERAL COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
b.fedotin@kcc.ks.gov

CARLY MASENTHIN, LITIGATION COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
c.masenthin@kcc.ks.gov

KYLER C. WINEINGER, LITIGATION

COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
k.wineinger@kcc.ks.gov

JANET BUCHANAN, DIRECTOR-REGULATORY AFFAIRS / OKE 13165
KANSAS GAS SERVICE, A DIVISION OF ONE GAS, INC.
7421 W 129TH STREET
OVERLAND PARK, KS 66213
janet.buchanan@onegas.com

LORNA EATON, MANAGER OF RATES AND REGULATORY AFFAIRS
KANSAS GAS SERVICE, A DIVISION OF ONE GAS, INC.
7421 W 129TH STREET
OVERLAND PARK, KS 66213
lorna.eaton@onegas.com

ROBERT E. VINCENT, MANAGING ATTORNEY
KANSAS GAS SERVICE, A DIVISION OF ONE GAS, INC.
7421 W. 129TH STREET
OVERLAND PARK, KS 66213
robert.vincent@onegas.com

DON KRATTENMAKER, Vice President
WOODRIVER ENERGY, LLC
633 17th STREET, STE. 1410
DENVER, CO 80202
don.krattenmaker@woodriverenergy.com

/s/ Robert Elliott Vincent
Robert Elliott Vincent, KS Bar No. 26028
Managing Attorney
KANSAS GAS SERVICE
A Division of ONE Gas, Inc.
7421 West 129th Street
Overland Park, Kansas 66213-5957
(913) 319-8615 Phone
(913) 319-8622 Fax
robert.vincent@onegas.com