

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 ) Docket No. 18-KGSG- 560 - RTS  
State of Kansas. )

**DIRECT TESTIMONY**  
**OF**  
**DICK F. ROHLFS**  
**ON BEHALF OF KANSAS GAS SERVICE**  
**A DIVISION OF ONE GAS, INC.**

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1       **I.       Position and Qualifications**

2       **Q.       Please state your name and business address.**

3       A.       Dick F. Rohlfs, 4330 SW Cambridge Ave, Topeka, Kansas 66610.

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

5       A.       I am a self-employed consultant.

6       **Q.       Please describe your educational background and business experience.**

7       A.       I graduated from the University of Northern Iowa with a Bachelor of Arts degree with an  
8       accounting major. My utility regulatory experience began in 1976 when I was employed by  
9       the Iowa State Commerce Commission now known as the Iowa Utilities Board. In 1980, I  
10      joined the Staff of the Kansas Corporation Commission (“Commission” or “KCC”) as a Utility  
11      Auditor advancing to Senior Utility Auditor. In 1982, I accepted a position with Kansas Gas  
12      and Electric (“KGE”) Company as a rate auditor, advancing to Senior Regulatory Accountant.  
13      In 1992, with the merger of The Kansas Power and Light Company with KGE, I accepted a  
14      position as a Regulatory Coordinator advancing to Director of Retail Rates. I retired from  
15      Westar Energy, Inc. (“Westar”) in 2014. Shortly after my retirement I started my consulting  
16      service.

1       **II.       Executive Summary**

2       **Q.       What is the purpose of your testimony?**

3       A.       I have noticed over the last several years that Commission Staff witnesses have included a  
4               general section in their testimony which explains to the Commission the underlying public  
5               utility regulatory principles Staff followed in conducting their audit and in making their  
6               adjustments and recommendations.<sup>1</sup> I have also noticed the utilities, for the most part, have  
7               elected not to include a similar section in their direct testimony. Kansas Gas Service (“KGS”  
8               or “Company”) asked if I could discuss some of the basic underlying public utility regulatory  
9               principles which should be followed in setting rates. My testimony provides the Commission  
10              with background information concerning history and goals of public utility regulation, a  
11              review of the Commission’s past practices, and the basic elements of effective rate regulation.  
12              Additionally, I discuss the relationship between depreciation rates and modernization of the  
13              Company’s distribution system in the context of my general discussion regarding effective  
14              ratemaking. Finally, I sponsor the request being made by the Company to implement a  
15              depreciation expense deferral mechanism.

16       **III.       Balance is the Key to Effective Regulation**

17       **Q.       Mr. Rohlfs, can you share your perspective on the purpose of utility rate regulation?**

18       A.       Yes. In the final months of my time at Westar and during my consulting career, I have had the  
19              opportunity to reexamine my many years in the Kansas regulatory arena to assess the purpose  
20              and practice of effective utility rate regulation. Generally, the purpose of regulation is to align  
21              private behavior of public utilities with public interests. More specifically, in terms of effective

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<sup>1</sup> Direct Testimony of Andria Finger, Docket No. 15-KCPE-116-RTS (“KCPL 2015 Rate Case”) filed May 11, 2015, page 8, line 13 through page 10, line 12; Direct Testimony of Justin Grady, Docket No. 12-WSEE-112-RTS (“Westar 2012 Rate Case”) filed January 5, 2012, page 8, line 1, through page 10, line 11; Direct Testimony of Andria N. Jackson, Docket No. 16-KGSG-491-RTS (“KGS 2016 Rate Case”) filed September 7, 2016, page 9, line 2 through page 11, line 11.

1 regulation of utility rates, regulation should strike a balance between the interests of a utility's  
2 customers, its investors and the general public. Of course, how that "balancing act" is  
3 accomplished by the regulator is the key to effective utility rate regulation.

4 In discussions of effective regulation, I find value in referring to the 1982 monograph on  
5 the Commission written by Mr. Brian Moline.<sup>2</sup> Mr. Moline was a good friend of mine and one  
6 of those effective rate regulators during his many years at the Commission, first as General  
7 Counsel, and later as Commissioner and Chairman. From a practical standpoint, he  
8 emphasized two important points with respect to this concept of proper regulatory balance  
9 and effective rate regulation. First, he stated that effective utility rate regulation is  
10 "essentially a series of tradeoffs."<sup>3</sup> Those tradeoffs include things like deciding between  
11 short-term and long-term policies and goals; or deciding between rate impacts on certain  
12 classes of customers on the one hand and what he referred to as "economic and technical  
13 realities" on the other hand.<sup>4</sup> With respect to this first point, Mr. Moline recognized the  
14 significance of the "regulatory compact," which I discuss in some detail below.<sup>5</sup> Later on in  
15 my testimony, I discuss the new depreciation rates offered by KGS. In that discussion I suggest  
16 how an effective regulatory decision can be made regarding that request by applying this first  
17 point made by Mr. Moline.

18 The second point made by Mr. Moline was the importance of the role played by the value  
19 judgments of the decision makers in the ratemaking process.<sup>6</sup> He referred to it as "regulatory  
20 discretion."<sup>7</sup> He acknowledged that the value judgments of the Commissioners are "an

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<sup>2</sup> Monograph of the KCC, Brian J. Moline (1982), a portion of which was published at 33 U.Kan.L.Rev. 509 (1984-1985) ("Moline Monograph").

<sup>3</sup> Moline Monograph, Preface.

<sup>4</sup> *Id.*

<sup>5</sup> Moline Monograph, Chapter 4, page 22.

<sup>6</sup> *Id.*, Preface.

<sup>7</sup> *Id.*, Preface.

1 inevitable and desirable component of the regulatory process.”<sup>8</sup> However, Mr. Moline was  
2 also quick to express that those value judgments and the regulatory discretion exercised by  
3 the Commissioners will “have important consequences for both ratepayers and stockholders  
4 of regulated enterprises” and a significant impact on the effectiveness of rate regulation.<sup>9</sup>  
5 Later on in my testimony, I discuss this second point in reference to the Commission’s recent  
6 decisions regarding returns on equity (“ROE”).

7 **Q. You referred to the term “regulatory compact.” What is the meaning of that term and how**  
8 **does it relate to effective utility ratemaking?**

9 A. Referring back to Mr. Moline’s monograph on the Commission, he explained the “regulatory  
10 compact” from a practical standpoint and in terms of how it applied to this Commission’s  
11 obligations in the ratemaking process as follows:

12 Because public utilities are generally given the exclusive right to operate in their  
13 service territory and are not usually subject to the pricing constraints of  
14 competition, the law provides that their rates shall be regulated. Kansas statutes,  
15 and the State and Federal Constitutions as interpreted by the courts, require that  
16 the Commission not be arbitrary in fixing utility rates. The Commission is required  
17 to grant to the utility company rates which will enable it to recover its **legitimate**  
18 expenses and an opportunity to earn a reasonable return on the investment it  
19 has made to provide service to the public. The purpose of Commission rate  
20 hearings is to place before the Commission evidence relating to reasonable  
21 operating revenues and expenses of the company, the appropriate rate of return  
22 on the investment of the company, and rate schedules that will permit the utility  
23 an opportunity to recover its revenue requirements in a nondiscriminatory  
24 manner.

25  
26 The utility companies are never guaranteed a return by the Commission; they are  
27 given the opportunity to earn an appropriate level of return through the schedule  
28 of rates charged to the consumer. That appropriate level of return has been  
29 construed by the courts to be what is earned by other businesses having  
30 comparable risks, and which is sufficient to permit the utility to be financially  
31 viable.<sup>10</sup> (Emphasis added)  
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<sup>8</sup> *Id.*, Preface.

<sup>9</sup> *Id.*, Preface.

<sup>10</sup> Moline Monograph, Chapter 4, Page 22.

1           A publication, which closely follows the utility industry, recently described this term, more  
2 generally, but still very consistent with Mr. Moline’s definition:

3           The regulatory compact is an agreement codified by statute and case law that is  
4 unique to the utility space and calls for: the utility to provide safe, reliable, and  
5 reasonably priced service; the commission to provide the utility with a reasonable  
6 opportunity to recover its costs and earn a return similar to that of other  
7 investments that have similar risk characteristics; the customer to pay the  
8 approved rates; and, the investor to supply the capital necessary to maintain or  
9 expand the utility system.<sup>11</sup>

10          The principles underlying the regulatory compact or bargain between utilities and their  
11 regulators are: (1) customers should not have to pay more than the reasonable and prudent  
12 costs incurred by the utility to provide efficient service to customers; and (2) customers  
13 should only pay for those costs and the prudently incurred investment that is being used by  
14 the utility to provide utility services. The counterbalance to these principles is that: (1) there  
15 should be universal agreement with the regulatory principle that rates should not be set so  
16 low that the utility is unable to recover its reasonable and prudent costs of providing service;  
17 and (2) rates should not be set in a way such that customers avoid paying for those reasonable  
18 and prudent costs and for the utility investment in facilities used to serve customers. As  
19 suggested by Mr. Moline, the principle or *goal* of effective ratemaking should be to set rates  
20 in a manner that does not stack the deck in favor of either the utility or the customer.<sup>12</sup> This  
21 “balancing act,” which is the basis for the bargain between utilities and their regulators under  
22 the regulatory compact is the key to effective rate regulation.

23          In the perfect regulatory world, finding the equilibrium between customer and  
24 shareholder’s rights is the goal. In this environment, rates would be set so a utility would  
25 recover exactly (no more or no less) the reasonable, necessary and prudent costs of providing

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<sup>11</sup> Regulatory Research Associates, “The Rate Case Process: A Conduit to Enlightenment,” Regulatory Focus, September 13, 2016, page 1.

<sup>12</sup> 33 U.Kan.L.Rev. at 510.

1 service to customers plus earn its authorized rate of return on its investment used to provide  
2 service to customers as determined by the regulator.<sup>13</sup> To suggest a ratemaking process,  
3 which meets this goal, somehow favors the utility over the customer is untenable. For  
4 example, the purchase gas adjustment (“PGA”) clauses and energy cost adjustment (“ECA”)  
5 clauses this Commission has had in place for nearly 40 years allow the gas and electric utilities  
6 to recover their actual prudent gas supply and fuel costs. Such ratemaking mechanisms meet  
7 the goal of a perfect regulatory process and comply with the regulatory compact made  
8 between the utility and its regulator.

9 Later in my testimony I discuss the issue of regulatory lag in the context of KGS’s proposed  
10 depreciation expense tracker. In past cases, both Staff and CURB have suggested that trackers  
11 or riders that eliminate some of the regulatory lag experienced by utilities under the  
12 Commission’s traditional ratemaking process somehow results in the regulatory deck being  
13 stacked against customers and in favor of the utilities. However, if those trackers or riders  
14 are set up in a manner similar to the PGA and ECA clauses, where the utility is only allowed to  
15 recover its actual and prudent costs (no more and no less) then it is unreasonable for Staff  
16 and CURB to suggest that such alternative ratemaking mechanisms favor the utility over the  
17 customer. They do not. Instead, these types of alternative ratemaking mechanisms simply  
18 improve on the efficiency of the ratemaking process.

19 To achieve the proper balance between customers and shareholders and to create a more  
20 effective ratemaking process, traditional ratemaking is evolving (which was one of the  
21 chapters in Mr. Moline’s monograph on the Commission).<sup>14</sup> There is a growing trend among  
22 public utility commissions toward authorizing alternative ratemaking approaches that allow

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<sup>13</sup> *Id.*

<sup>14</sup> Moline Monograph, Chapter 3, Evolution of the Kansas Corporation Commission, pages 13-15.

1 the utility to recover their actual prudently incurred costs as audited and approved by the  
2 commission. The revenue normalization adjustment (“RNA”) and the cyber security and  
3 depreciation expense trackers being proposed by KGS in this present case are good examples  
4 of alternative ratemaking mechanisms that fully comply with the regulatory principles which  
5 form the basis for the regulatory compact. These mechanisms should not be summarily  
6 dismissed simply because they are alternatives to the traditional ratemaking process. Instead,  
7 these mechanisms should be reviewed in the context of whether they will do a better job at  
8 balancing the rights of the customers and shareholders and create a more efficient  
9 ratemaking process.

10 **Q. Can you provide an example where in recent years the regulatory compact has not been**  
11 **followed?**

12 A. Yes. A good example of where the regulatory compact has not been followed in recent years  
13 relates to the issue of whether a utility should be allowed to recover the total cost of  
14 employee compensation. Until recently, the Commission allowed utilities to recover the total  
15 actual amount paid to its employees in connection with its provision of utility service provided  
16 the utility could show that: (1) the utility incurred the costs; (2) the total compensation paid  
17 to employees was equal to or below market-based salaries; (3) the portion of the total  
18 compensation paid to employees, which was variable, and at-risk, was based upon incentives  
19 to meet certain criteria or goals that were important to customers, employees and  
20 shareholders; and (4) the utility was providing efficient and sufficient service to its  
21 customers.<sup>15</sup> Decisions from these past rate cases, where the Commission allowed the utility

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<sup>15</sup> Docket No. 99-WPEE-818-RTS, Order on Application dated January 19, 2000, page 18, paragraph 38, (utility should be allowed to include incentive compensation and bonuses as part of the payroll expense recoverable in its cost of service over Staff's objection because compensation plan was designed to create a financial incentive for utility employees to achieve goals important to customers, employees and shareholders). Docket No. 04-AQLE-1065-RTS, Order on Application dated January 28, 2005, page 11, paragraph 36; Order on Reconsideration dated March 14,



1 to recover the total actual cost of what it paid its employees, complied with the principle  
2 underlying the regulatory compact for the following reasons:

3 (a) Hiring and retaining a qualified work force is essential for any utility to be able to  
4 provide safe and sufficient service to its customers and utility customers clearly benefit from  
5 being served by a qualified work force;

6 (b) The cost to fairly compensate such a qualified work force is a reasonable and  
7 necessary (prudent) cost of providing service to customers and should be included in the  
8 utility's cost of service in setting rates;

9 (c) Such costs should be allowed to be recovered in rates when there is no successful  
10 challenge as to whether the costs have been incurred by the utility and no successful  
11 challenge alleging the total costs incurred to compensate employees were imprudent or  
12 unreasonable based upon market-based salaries for those positions;

13 (d) To the extent that the total compensation includes 'at-risk' or 'incentive  
14 compensation', such arrangements are typical in the utility industry and is a widely accepted  
15 form of compensation used to incentivize employee performance. A utility's failure to provide  
16 such form of compensation would place the utility at a competitive disadvantage in the hiring  
17 of qualified employees; and

18 (e) The Commission has not identified evidence that the utility is failing to provide  
19 efficient and sufficient service to its customers.<sup>16</sup>

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2005, page 32, paragraph 79 (where the utility's two-part compensation program that includes fixed compensation and variable compensation is designed to encourage employees to achieve goals important to all stakeholders, customers, employees and shareholders and is developed from a balanced set of metrics associated with service reliability, safety, customer services and the effective use of capital; and the utility's overall total compensation is equal to or below the market average for just compensation; that total compensation should be allowed in rates over the objections of Staff and CURB).

<sup>16</sup> *Id.*

1           Allowing the recovery in rates of the total compensation paid to employees, where the  
2           compensation program meets the above-mentioned factors and has resulted in excellent  
3           performance (as the program is intended to do), means the regulator has lived-up to its side  
4           of the bargain under the regulatory compact. However, in recent rate cases the Commission  
5           has determined, without cause and without any explanation, to move away from its previous  
6           decisions on this issue.<sup>17</sup> This change constitutes a perverse form of punishment of a utility  
7           for success in supporting and rewarding high-performance by its employees, and is clearly a  
8           breach of the regulatory compact on the part of the regulator.

9           **Q. Can you explain why the recent recommendations by the Commission Staff and CURB to**  
10           **disallow recovery in rates of some or all the variable, at-risk, incentive compensation**  
11           **portion of the total compensation paid to employees (and the Commission’s acceptance of**  
12           **such recommendations, without any explanation as to why it has decided to move away**  
13           **from its previous decisions on this issue), results in a breach of the regulatory compact?**

14           A. Yes. As I previously mentioned, the main principle of utility regulation underlying the  
15           regulatory compact between the utility and its regulator is the utility shall be given the  
16           reasonable opportunity to recover actual costs that are reasonably, necessarily and prudently  
17           incurred in connection with its provision of utility service. If the total compensation paid to  
18           employees is reasonable based upon those employees’ total compensation being at or below  
19           the market for those employees; if those employees are necessary to provide efficient and  
20           sufficient service to customers; if those employees’ total compensation is prudently incurred  
21           in connection with the utility providing service to customers; and, if the customers are being  
22           provided efficient and sufficient service; then under the regulatory compact the utility should

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<sup>17</sup> Docket No. 10-KCPE-415-RTS, Order dated November 22, 2010, pages 46-51.

1 be allowed to recover the cost of total compensation paid to those employees. To disallow  
2 some or all the portion of variable or at-risk compensation, means the utility is not allowed to  
3 recover the total compensation paid to its employees, even though the expense is one that is  
4 incurred, necessary and prudent in connection with the utility providing service to its  
5 customers.

6 The main factor the Commission should consider in deciding this issue is whether the total  
7 employee compensation level (the base pay plus the at-risk incentive pay, including both  
8 short-term and long-term incentive pay) is reasonable relative to the market. The at-risk  
9 incentive pay, included in the total employee compensation, should not be arbitrarily  
10 disallowed simply because it is classified as at-risk incentive compensation. If at-risk incentive  
11 compensation were arbitrarily disallowed simply because of its nature, then the total cost of  
12 employee compensation included in rates would fall below what is already at or below the  
13 market-average. This means the employee compensation levels included in rates would be  
14 significantly less than what the utility actually pays its employees and significantly below what  
15 the market-based compensation would be for these employees. Such regulatory treatment  
16 means the utility is prevented from recovering the actual costs paid to its employees even  
17 though those costs have been incurred and are proven to be reasonable, necessary and  
18 prudent. That is a clear breach of the regulatory compact.

19 I'd like to make an additional point regarding the current ratemaking treatment afforded  
20 to incentive compensation and how such treatment violates the regulatory compact. One of  
21 the reasons given for disallowing some or all the incentive compensation portion of the total  
22 compensation paid to employees is that shareholders should have to pay for a portion of the  
23 employees' salaries because the shareholders benefit from the work performed by the  
24 employees. The problem with such an argument is that it could be made to exclude a portion

1 of most, if not all, costs incurred by the utility, since most costs incurred by the utility provide  
2 some benefit to both the customer and the shareholder. However, if the Commission  
3 adopted a policy where a portion of all of those reasonably incurred costs had to be paid by  
4 shareholders because the shareholder benefitted from the utility incurring those costs, then  
5 a utility would never have a reasonable opportunity to earn a fair return on the service  
6 provided to customers. A second reason given for disallowing the cost is that the incentive  
7 could lead to customers receiving inefficient or insufficient service. However, if there is no  
8 evidence that customers are receiving insufficient service, then there is no basis for this  
9 argument.

10 Finally, the last point I would like to make on this issue arises from my review of the 2010  
11 rate case order where the Commission changed its approach to recovery of total  
12 compensation, wherein there was no mention or discussion by the Commission of its earlier  
13 cases. In the Order, the Commission discussed neither the factors considered in those prior  
14 cases to allow for recovery of the total compensation paid to employees nor provided reasons  
15 why those factors were no longer appropriate for evaluating compensation.<sup>18</sup> The earlier  
16 Commission decisions regarding this issue were much more in line with the principle  
17 underlying the regulatory compact. However, the 2010 decision was contrary to that principle  
18 and breaches the regulatory compact. The Commission in this case should, at a minimum,  
19 take a fresh look at this issue in the context of which line of cases best meets its obligation  
20 under the regulatory compact. If that analysis is done properly, then it should be clear that  
21 the line of cases prior to 2010 should be followed by this Commission.

22 **Q. Earlier in your testimony, you were discussing the characteristics of effective and balanced**  
23 **ratemaking. You mentioned Mr. Moline's point on regulatory discretion being influenced**

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<sup>18</sup> *Id.*

1           strongly by the value judgments of the Commissioners and Moline’s opinion that such value  
2           judgments are a desirable component of the regulatory process, provided the  
3           Commissioners were aware of how their use of that discretionary power had important  
4           consequences for both customers and shareholders. You also mentioned how the  
5           Commission’s recent decisions regarding utility ROEs might be used to demonstrate Mr.  
6           Moline’s point and how it related to effective ratemaking. Can you explain what you meant  
7           by those statements?

8           A. Yes. Prior to the last few years, as far back as I recall (including that portion of my career that  
9           I spent working for the Commission Staff), this Commission’s decisions regarding utility ROEs  
10          have consistently been very much in line with the ROEs set by a majority of the other state  
11          commissions. This alignment was typically thought of as evidence of the Commission  
12          exercising its regulatory discretion in a way that balanced the rights of the customers and the  
13          shareholders. It was viewed as recognition of the important consequences attached to the  
14          exercise of that regulatory discretion for both customers and shareholders as referred to by  
15          Mr. Moline. However, in recent years, the Commission’s decisions regarding utility ROEs have  
16          drastically shifted to where the ROEs for all Kansas utilities are now among the lowest in the  
17          country. This fact calls into question whether effective and balanced ratemaking is being  
18          threatened by the use of the regulatory discretion. It also brings to the forefront the  
19          significant consequences of the use of regulatory discretion in identifying what goes into  
20          creating a balanced and effective ratemaking process.

21          **Q. What are the important consequences of the Commission’s decision to use its regulatory**  
22          **discretion to set the lowest ROEs in the country for Kansas gas and electric utilities?**

23          A. The Commission’s use of its regulatory discretion to set the lowest ROEs in the country for  
24          Kansas gas and electric utilities has resulted in a degradation of the regulatory climate or

1 environment in Kansas. It has seriously called into question whether the Commission is  
2 stacking the ratemaking deck against the utilities. For example, the Regulatory Research  
3 Associates (“RRA”) provides rankings of utility regulatory agencies throughout the country.  
4 The ranking for the Commission, as of March 23, 2018, is “Below Average/1” from an investor  
5 perspective. In May 2017, RRA downgraded the Commission from “Average/2” to “Below  
6 Average/1”, which was a significant downgrade. RRA states that a below average ranking  
7 indicates “. . . a less constructive, higher-risk regulatory climate from an investor viewpoint.”<sup>19</sup>  
8 An investor’s perspective of the regulatory environment is important since, among other  
9 things, it affects the utility’s ability to attract capital. The RRA provided the following  
10 comments regarding the regulatory climate in Kansas as of September 19, 2017:

11 Kansas regulation is relatively restrictive from an investor perspective. Although  
12 base rate proceedings in Kansas are typically resolved via "black box" settlements  
13 that do not specify any rate-of-return parameters, the KCC's most recent equity  
14 return authorization, a 9.3% ROE approved in a September 2015 electric rate case  
15 decision, was significantly below prevailing industry averages at the time  
16 established. ... In May 2017, RRA performed a comprehensive audit of its  
17 regulatory rankings. The ranking accorded Kansas was lowered as a result of this  
18 process. RRA now accords Kansas a Below Average/1 ranking, versus the previous  
19 Average/2 ranking, and the new ranking reflects the state's gradual shift toward  
20 a more "consumerist" approach to ratemaking, . . .<sup>20</sup>  
21

22 **Q. Is there another recent example of where balanced and effective ratemaking was**  
23 **threatened by the important consequences of the use of regulatory discretion?**

24 A. Yes. I noted a reference made by one of the gas utilities in the Commission's recent general  
25 investigation regarding the acceleration of replacement of vintage pipe, Docket No. 15-GIMG-  
26 343-GIG ("343 Docket"). The reference was to a published comment made by Moody's  
27 Investor Services ("Moody's", a rating agency that follows the gas and electric utility industry),

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<sup>19</sup> RRA Regulatory Focus, “State Regulatory Evaluations”, March 23, 2018, page 1.  
<sup>20</sup> SNL/RRA website

1 shortly after the Commission issued its non-unanimous decision in the 343 Docket. The  
2 reference to the Moody's quote was as follows:

3 See, Moody's Investor Services' Issue Comment dated September 22,  
4 2017, "Cap on Cost Recovery of Pipe Replacements—Credit Negative  
5 for Kansas Utilities," where it indicates the ARP mechanism places gas  
6 utilities in a difficult position since the program is far from sufficient  
7 to cover all of the necessary investment to meet the stated goal and  
8 is unlike other accelerated pipeline replacement programs that exist  
9 in over 40 states.<sup>21</sup>  
10

11 This is a good example where the Commission's use of its regulatory discretion will likely have  
12 negative consequences impacting the balance between customer and shareholder interests  
13 and effective ratemaking.

14 **Q. Please discuss the information provided in the three tables below.**

15 A. The first table compares the ROEs proposed by Staff, adopted by the Commission for natural  
16 gas utilities in Kansas for the period between 2012-2017, and the average of the ROEs set for  
17 gas utilities by other state commissions during that same time frame. As shown in the table,  
18 the only specified ROE for natural gas utilities in Kansas (as reported by SNL) over the period  
19 was 9.1%. The average of the ROEs set by the other state commissions during that same  
20 period ranged from 9.54% to 9.94%.

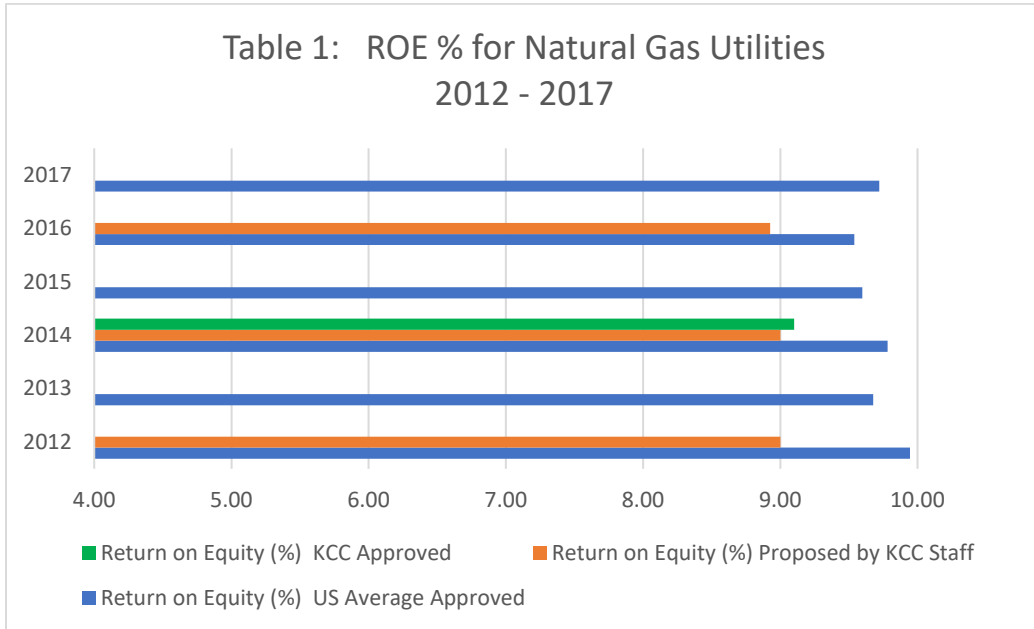
21 The second table shows the same comparison of the ROEs proposed by Staff established  
22 by the Commission for electric utilities in Kansas (an average of 9.6% for the entire period)  
23 and the average of the ROEs set for electric utilities during each year of the same period by  
24 other state commissions (an average of 9.91% for the entire period).

25 The third table makes that same comparison for electric utilities for 2005-2011. It shows  
26 the ROEs set for electric utilities in Kansas were much closer to the average of the ROEs set

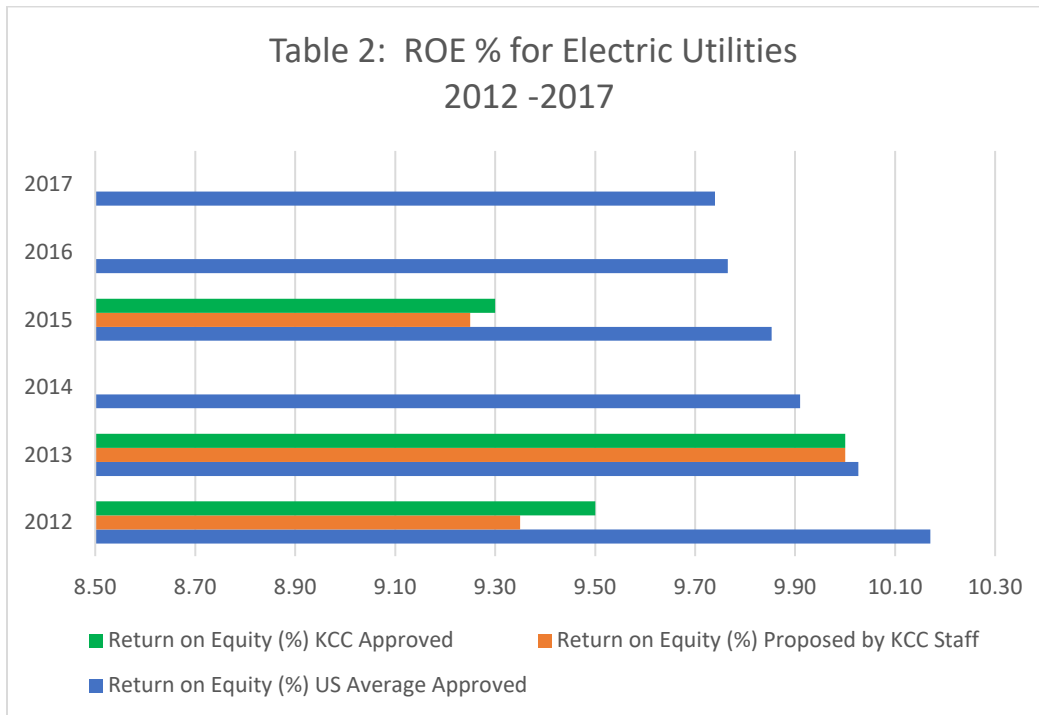
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<sup>21</sup> Petition for Reconsideration of Atmos Energy Corporation, Docket No. 15-GIMG-343-GIG, September 27, 2017, Footnote 1, page 3.

1 by the other state commissions during that same period. (Note that there were no specified  
 2 ROEs for natural gas utilities in Kansas reported by SNL during this time.)

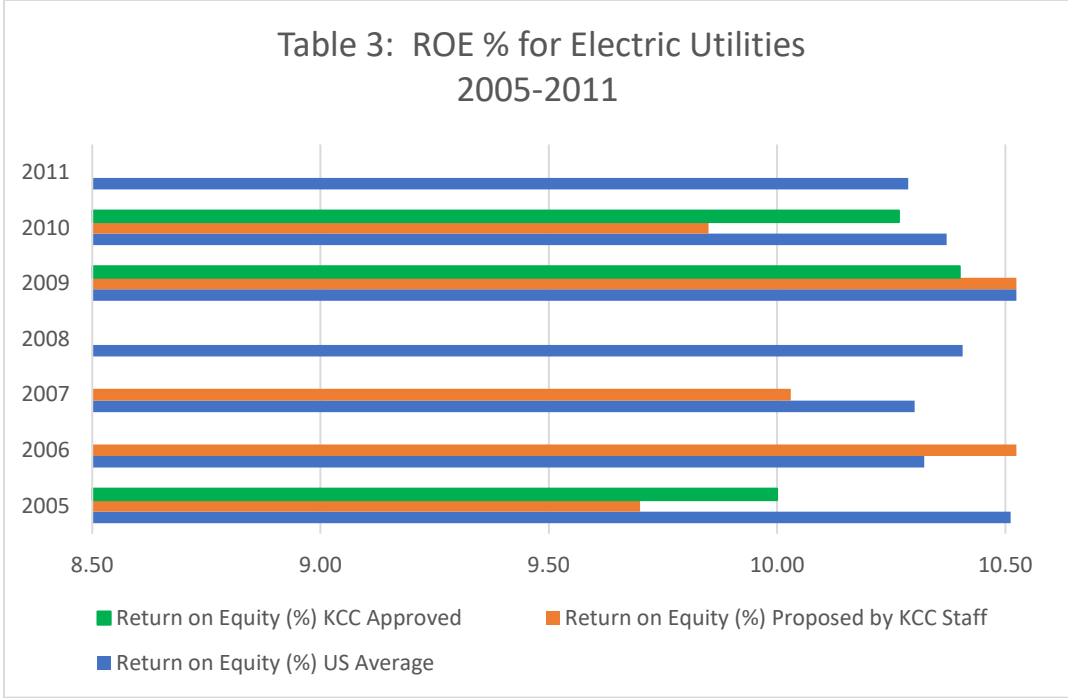


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SNL: Data accessed 5/26/2018; KCC Staff Testimony

RRA Regulatory Focus, a publication which closely follows the utility industry, states that ROEs for the first quarter of 2018 are similar to those approved in 2017 and are in the range of 9.68% for natural gas utilities.<sup>22</sup>

**Q. Are the proposals included in KGS’s rate case filing designed to promote effective ratemaking and to comply with the regulatory compact?**

A. Yes. If the goal of effective ratemaking is to provide the utility an opportunity to earn an appropriate level of return through the schedule of rates charged to customers, as is suggested by Mr. Moline, then KGS’s rate case filing meets that goal. On the contrary, authorizing a utility’s ROE at a level that is the lowest in the country, disallowing prudently incurred costs (such as short-term and long-term incentive compensation), setting depreciation rates that are too low and approving a rate design that doesn’t allow the utility to collect its revenue requirement will not promote effective ratemaking and will not comply

<sup>22</sup> RRA Regulatory Focus, “US Energy Utility Focus To Remain on Tax Reform, Regulatory Reform and Mergers,” May 2, 2018, page 2.

1 with the regulatory compact. KGS's rate case filing addresses each of these and other issues  
2 in a reasonable manner and if the Commission uses its "regulatory discretion" and its "value  
3 judgment," as suggested by Mr. Moline, in making decisions in this rate case, then the result  
4 should be an effective rate making process which properly balances the interests of the  
5 customers and the utility's shareholders.

6 **IV. Depreciation Rates and Infrastructure Modernization**

7 **Q. In your earlier comments you mentioned how the first point made by Mr. Moline that**  
8 **effective ratemaking is essentially a series of trade-offs could be applied in the present**  
9 **case to decide the issue or depreciation rates. Can you explain what you meant?**

10 A. Yes. Take the two examples of the trade-offs mentioned by Mr. Moline in his monograph on  
11 the KCC: (1) the trade-off between short- and long-term goals; and (2) the trade-off between  
12 maintaining lower rates and economic and technical realities. The Commission in its recent  
13 343 Docket dealing with aging infrastructure acknowledged that the utility industry, other  
14 infrastructure industries, and gas utilities (and for that matter electric utilities) in particular,  
15 found themselves, along with their regulators, in a position of having to play catch-up with  
16 respect to the replacement of vintage pipe. A candid reflection on that issue and how utilities  
17 and regulators found themselves in that position has to do, in part, with the trade-offs the  
18 Commission has made over the years in setting depreciation rates for gas utilities. Funding  
19 system improvements through depreciation expense is difficult since new investment is  
20 generally more expensive than the original plant on which depreciation expense is calculated.  
21 This issue is exacerbated when the Commission's decisions increase the lives of assets and  
22 decrease the utilities' depreciation expense. This certainly achieved the short-term policy or  
23 goal of maintaining lower customer rates. However, the economic and technical realities of  
24 those decisions came at the expense of perhaps a better long-term policy or goal of

1 establishing more reasonable lives of assets to allow for a more reasonable level of  
2 depreciation expense that then could be used by the utility to replace its aging infrastructure.  
3 While gas utilities have noted deficiencies in the actions taken by the Commission in the 343  
4 Docket, the Commission attempted, through its orders in that docket, to push the reset  
5 button in an effort to address the aging infrastructure issue. Whether the Commission can  
6 continue to make progress on this issue and, once resolved, avoid a recurrence in 50 years  
7 depends on the trade-offs the Commission elects to make this time around in setting  
8 depreciation rates and the depreciation expense allowed in KGS's cost of service. Effective  
9 rate regulation would suggest that the Commission must take a closer look at the  
10 ramifications of how it decides to set depreciation rates and expenses in this rate case. I  
11 would suggest that to avoid the potential for new aging infrastructure issues 50 years from  
12 now, the proper trade-off would be to allow for a more reasonable level of depreciation rates  
13 and expenses, as proposed by KGS, in this case.

14 **V. KGS's Proposal for a Depreciation Expense Tracker**<sup>23</sup>

15 **Q. Why is KGS proposing a depreciation expense tracker?**

16 A. The goal of effective ratemaking is to provide the utility an opportunity to earn an appropriate  
17 level of return through the schedule of rates charged to customers. However, regardless of  
18 the level of return approved by the Commission, other factors such as changes in capital  
19 structure, changes in rate base, expense disallowances, etc., make it unlikely that a utility will  
20 earn the authorized level of return. A significant factor in the inability to earn the authorized  
21 return is "regulatory lag." Regulatory lag is generally defined as the time between the period  
22 when costs for a utility change and the point in time when the Commission recognizes the

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<sup>23</sup> When referring to depreciation expense, I am including expense recorded in FERC Accounts 403 – Depreciation Expense which includes both depreciation and amortization expense.

1 cost changes either by raising or lowering rates. Because rates are established based on  
 2 expenses and rate base that are “stale”, a utility will not be able to earn its authorized return.  
 3 KGS is proposing the depreciation tracker to help address this issue.

4 **Q. Can KGS demonstrate the impact regulatory lag has had on the Company?**

5 A. Yes. KGS provides the following information demonstrating regulatory lag related to changes  
 6 in plant and in depreciation expense. I provide the data as an illustration of the need for non-  
 7 traditional ratemaking mechanisms such as the depreciation tracker. However, questions  
 8 concerning the detail behind this summary information should be directed to Company  
 9 Witness Mark Smith.

Impact of Regulatory Lag					
	Unrecovered Dollars Associated with Return on Capital Investment	Unrecovered Dollars Associated with Depreciation	GSRs Recovery	Unrecovered Dollars	ROE Basis Points Lost
2015	\$9,570,218	\$5,996,562	(\$5,209,371)	\$10,357,410	209.11
2016	\$14,618,922	\$7,209,301	(\$6,839,706)	\$14,988,517	270.05
2017	\$5,192,846	\$1,516,989	(\$241,667)	\$6,468,168	110.13
2018*	\$9,741,881	\$3,342,541	(\$2,900,000)	\$10,184,422	178.92

\* Estimate

11  
 12 The data clearly show the financial burden KGS has faced because of regulatory lag over the  
 13 last several years. For this time period, over 40% of the regulatory lag is related to  
 14 depreciation expense.

15 As demonstrated in the table above, the level of depreciation and amortization expense  
 16 in base rates is not reflective of the Company’s ongoing depreciation expense. As previously  
 17 mentioned, funding system improvements through depreciation expense is difficult since new  
 18 investment is generally more expensive than the original plant on which depreciation expense

1 is calculated. This issue is exacerbated when the Commission approves lower depreciation  
2 rates in favor of lower consumer rates in the short-term. The Company is then further  
3 hampered by regulatory lag which significantly reduces KGS's opportunity to earn its  
4 Commission authorized rate of return. As identified in the table, this lag reduces the  
5 Company's opportunity to earn its authorized return by up to 207 basis points. Therefore,  
6 under KGS's current regulatory scheme, the Company would need an authorized return of  
7 12.07% to have a reasonable opportunity to earn its requested ROE of 10%.

8 As KGS continues to invest at rates in excess of its approved depreciation expense to meet  
9 replacement requirements set by the Commission, federal regulatory requirements and to  
10 extend service to new locations, the Company's depreciation expense continues to grow. KGS  
11 proposes that a tracker be established to address this issue.

12 This tracker is similar to the ad valorem tax riders and the pension trackers that the  
13 Commission has approved for utilities after finding them an appropriate balance of the  
14 interests of customers and the utility. These trackers, and the proposed depreciation expense  
15 tracker are consistent with the regulatory compact discussed earlier in my testimony.  
16 Customers will pay no more than the reasonable and prudent costs incurred by KGS and the  
17 Company is able to recover reasonable and prudent costs in a timely manner.

18 **Q. How would the depreciation expense tracker work?**

19 A. KGS would establish a regulatory asset or regulatory liability to track the difference between  
20 the depreciation expense recognized in rates (including depreciation expense embedded  
21 within the GSRS calculation) and the actual direct and indirect depreciation expense incurred  
22 each year. In the first month following the Commission's Order in this docket, KGS will start  
23 to record depreciation as a regulatory asset or liability (depreciation deferral). By March 31<sup>st</sup>  
24 of each year, KGS would provide a report comparing the current balance in FERC Account 403

1 – Depreciation Expense with the amount approved for this account in this proceeding, plus  
2 any additional amounts that have been approved in subsequent GSRS filings. The balance of  
3 the regulatory asset or liability would be recovered through amortization on a straight-line  
4 basis over three years within the context of a rate case proceeding. The regulatory asset or  
5 liability will not be a component of rate base in the Company’s next rate case proceeding nor  
6 will the deferred balances receive a carrying charge in that proceeding.

7 **Q. Can you provide an example?**

8 A. Yes. The pro forma depreciation expense included in KGS’s filing is approximately \$64 million.  
9 Assume that rates implemented in 2019 are designed to recover this level of expense. Let’s  
10 also assume that Staff and KGS have agreed to evaluate current depreciation expense each  
11 December 31<sup>st</sup> and KGS reports that the depreciation expense on its books during that 12-  
12 month period is \$67 million. KGS would defer \$3 million as a regulatory asset (\$67 million -  
13 \$64 million = \$3 million). In the following year, assume KGS had a GSRS filing that included  
14 \$750,000 in depreciation expense. At December 31<sup>st</sup>, KGS reports depreciation expense on  
15 its books during that 12-month period of \$70 million. KGS will defer an additional \$5.25  
16 million (\$70 million – (\$64 million + \$0.75 million) = \$5.25 million).

17 **VI. Conclusion**

18 **Q. Does this conclude your testimony?**

19 A. Yes, it does.

**VERIFICATION**

STATE OF KANSAS                    )  
  ) ss.  
COUNTY OF SHAWNEE            )

Dick F. Rohlf, being duly sworn upon his oath, deposes and states that he is an Independent Consultant for Kansas Gas Service, a division of 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.

  
\_\_\_\_\_  
Dick F. Rohlf

Subscribed and sworn to before me this 7<sup>th</sup> day of June 2018.

  
\_\_\_\_\_  
NOTARY PUBLIC

My appointment Expires:

06/05/2022

