

Kern River Gas Transmission Company

ORDER ON REHEARING, PROPOSED SETTLEMENT AND PAPER HEARING

126 FERC ¶ 61,034 (2009)

In this case, after a paper hearing, the Commission applied its Policy Statement styled *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (April 17, 2008) to determine the rate of return for Kern River Gas Transmission Company (Kern River). In finding a return on equity of 11.55 percent for Kern River, the Commission included three of four proposed Master Limited Partnerships (MLPs) in the proxy group. It included Northern Border Partners, LP, TC Pipelines, L.P. and Kinder Morgan Energy Partners, LP, but excluded Enterprise Products Partners, L.P. (Enterprise). The Commission excluded Enterprise because it was involved in a merger within the test year. This involvement created such uncertainty about its financial standing as to cause stock prices to be insufficiently reliable for use in the Discounted Cash Flow methodology. Further, unlike the other three MLPs and Kern River, Enterprise was primarily a natural gas liquids operation and not a natural gas transmission business.

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126 FERC ¶ 61,034
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Sudeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

Kern River Gas Transmission Company

Docket Nos. RP04-274-000
RP04-274-009
RP00-157-015

OPINION NO. 486-B

ORDER ON REHEARING, PROPOSED
SETTLEMENT AND PAPER HEARING

(Issued January 15, 2009)

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1. This order addresses the paper hearing on return on equity (ROE) issues established by Opinion No. 486-A,¹ BP Energy Company's (BP) rehearing request of that opinion, and a contested settlement filed by Kern River Gas Transmission Company (Kern River) on September 30, 2008. Based on the record established in the paper hearing, the Commission finds that Kern River's ROE should be 11.55 percent. That is the median ROE of a revised proxy group which includes both master limited partnerships (MLPs) and corporations, consistent with the Policy Statement adopted in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*.² Upon review of the comments on the settlement, the Commission finds that the higher 12.50 percent ROE embedded in the proposed settlement rates renders the settlement rates unjust and unreasonable, and accordingly the Commission rejects the settlement. The Commission also denies BP's rehearing request of certain ROE and other issues. Finally, the Commission directs Kern River to make a revised compliance filing.

I. Background

2. The background of this proceeding is described in detail in Opinion No. 486³ and Opinion No. 486-A. To summarize, when the Commission authorized Kern River to construct its Original System in 1990, the Commission approved initial rates based, among other things, on a levelized cost of service and a 25-year depreciation life.⁴ In addition, the Commission accepted Kern River's proposal for separate levelized rates for three different periods: (1) the 15-year term of the firm shippers' initial contracts, (2) the period from the expiration of those contracts to the end of Kern River's depreciable life, and (3) the period thereafter. The levelized rates for the first period (hereafter Period One Rates) were designed to permit Kern River to recover approximately 70 percent of its original investment, an amount approximately equal to the portion of its invested capital funded through debt. Since this would allow Kern River to recover more invested capital during Period One than it would under ordinary straight-line depreciation for the

¹ *Kern River Gas Transmission Co.*, 123 FERC ¶ 61,056 (2008) (Opinion No. 486-A).

² *Policy Statement on the Composition of Proxy Groups for Determining Gas and Oil Pipeline Return On Equity*, 123 FERC ¶ 61,048 (2008), *reh'g dismissed*, 123 FERC ¶ 61,259 (2008) (Policy Statement).

³ *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486).

⁴ *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069, at 61,150 (1990). *Kern River Gas Transmission Co.*, 58 FERC ¶ 61,073, at 61,242-44, *order on reh'g*, 60 FERC ¶ 61,123, at 61,437 (1992).

depreciable life of the project, the rates for the second two periods (hereafter Period Two and Period Three Rates) were lower than the Period One rates.

3. In May 2000, Kern River proposed to lower its rates by refinancing its debt and providing for longer debt recovery periods by extending the terms of its firm contracts. The Commission accepted a settlement containing this proposal, the 2000 Extended Term Settlement (2000 ET Settlement).⁵ As a result of the 2000 ET Settlement, all of Kern River's firm shippers extended their contracts. One group of customers extended their contract terms by five years and entered into revised contracts with ten-year terms (October 1, 2001 to 2011); the other group extended their contract terms by 10 years and entered into revised contracts with 15-year terms (October 1, 2001 – 2016). The 2000 ET Settlement provided that the firm shippers' rates under these contracts would be designed consistent with the principles espoused in its Original Certificate Order described above, permitting Kern River to recover 70 percent of the costs of the plant being depreciated by the end of the new repayment periods.⁶ Therefore, after the 2000 ET Settlement, two customer groups existed: 10-year ET shippers and 15-year ET shippers.

4. In May 2002, Kern River completed an expansion project by adding additional compression to its system.⁷ The costs associated with the 2002 Expansion project were rolled into the original system costs. As before, the 2002 Expansion shippers were permitted to choose 10- or 15-year terms for this additional capacity. Kern River stated that the rolled-in rate treatment of the costs for this project would result in recovery of the total debt-related depreciation expenses over the primary terms of the expansion

⁵ *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061 (2000) (*2000 ET Settlement*), *order on reh'g*, 94 FERC ¶ 61,115 (2001). Under the 2000 ET Settlement, Kern River did not require a general reallocation of revenue responsibility among its shippers and maintained that its cost of service (other than financing and depreciation components) would remain unchanged. *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061, at 61,156 (2000).

⁶ *Id.* at 61,157. Kern River stated that in designing its rates, cost of service and rate base components would first be allocated to each rate option based upon the percentage of contract demand of those shippers electing to pay the new 10-year rates, the new 15-year rates, and the existing rates. Then, the levelized rates for the 10-year and 15-year rate options would be calculated by levelizing the cost of service over the extended contracts terms, and the existing rates would be reduced as appropriate.

⁷ *Kern River Gas Transmission Co.*, 96 FERC ¶ 61,137 (2001).

shippers' contracts.⁸ In May 2003, Kern River completed another expansion project.⁹ Kern River priced these services on an incremental basis and again permitted shippers to choose either 10-year or 15-year firm contracts.

5. On April 30, 2004, Kern River filed the instant general rate case under section 4 of the NGA. Kern River proposed to continue using the rate levelization methodology and cost of service rate principles as approved in the original Kern River certificate,¹⁰ the 2000 Extended Term Settlement,¹¹ the 2003 Expansion certificate,¹² and the prior Kern River rate case settlements,¹³ with certain modifications.¹⁴ The Commission accepted and suspended the rates subject to refund, conditions, and hearing.¹⁵ The Presiding Administrative Law Judge (ALJ) issued her Initial Decision (ID) on March 2, 2006,¹⁶ addressing numerous cost of service and rate design issues, including Kern River's continuation of its levelized rate methodology and its proposed ROE.

6. On October 19, 2006, the Commission issued Opinion No. 486, addressing the briefs on and opposing exceptions to the ID, and on April 18, 2008, the Commission issued Opinion No. 486-A, addressing the requests for rehearing of Opinion No. 486. As a result of those opinions, the Commission has finally resolved on the merits most issues in this proceeding. The only issues which the Commission did not finally resolve concerned Kern River's levelized rates and its ROE.

⁸ *Kern River Gas Transmission Co.*, 96 FERC ¶ 61,137, at 61,591 (2001).

⁹ *Kern River Gas Transmission Co.*, 100 FERC ¶ 61,056, *order on reh'g*, 101 FERC ¶ 61,042 (2002).

¹⁰ *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069 (1990).

¹¹ *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061 (2000), *reh'g denied*, 94 FERC ¶ 61,115 (2001).

¹² *Kern River Gas Transmission Co.*, 100 FERC ¶ 61,056 (2002).

¹³ *Kern River Gas Transmission Co.*, 70 FERC ¶ 61,072 (1995); *Kern River Gas Transmission Co.*, 90 FERC ¶ 61,124, *order on reh'g*, 91 FERC ¶ 61,103 (2000).

¹⁴ A more detailed history of recent regulatory proceedings on Kern River's system is available in Opinion No. 486 at P 4-17.

¹⁵ *Kern River Gas Transmission Co.*, 107 FERC ¶ 61,215, *order on reh'g*, 109 FERC ¶ 61,060 (2004).

¹⁶ *Kern River Gas Transmission Co.*, 114 FERC ¶ 63,031 (2006).

7. On the levelized rate issue, Opinion No. 486 affirmed the ALJ's holding that Kern River's rates should continue to be designed based upon the levelized methodology.¹⁷ The Commission recognized that Kern River's Period One rates will recover more depreciation expense than it will have depreciated on its books. However, the Commission stated that Kern River books a regulatory asset or liability for the difference between the annual regulatory depreciation expense it recovers in rates and its book depreciation expense. Therefore, at the end of Period One, Kern River's books would reflect a regulatory liability, and this would serve to lower its Period Two rates. The Commission rejected a variety of arguments as to why shippers might not receive the benefit of the lower Period Two rates. However, in order to increase the assurance that Kern River's shippers will obtain the benefit of the lower Period Two rates if they continue service beyond the terms of their existing contracts, the Commission directed that Kern River include in its tariff the Period Two rates that will take effect when the firm shippers' existing contracts expire. Opinion No. 486-A denied rehearing of all of Opinion No. 486's holdings concerning Kern River's levelized rates. However, in its request for rehearing of Opinion No. 486-A, BP has requested that the Commission clarify certain issues concerning the design of Kern River's Period Two rates. BP also requests that the Commission clarify that Kern River's shippers will continue to get the benefit of their bargain in Period Three.

8. On the issue of Kern River's ROE, Opinion No. 486 reversed the ALJ's holding that Kern River's ROE should be 9.34 percent, holding that the ALJ had erred in her findings concerning the proxy group to be used in determining a range of reasonable returns in which to set Kern River's ROE. In Opinion No. 486, the Commission adopted a four-company proxy group consisting of Kinder Morgan Inc. (KMI), Equitable Resources, Inc. (Equitable), National Fuel Gas Co. (National Fuel), and Questar Corporation (Questar). In adopting this proxy group, Opinion No. 486 applied a revised proxy group policy, which had been developed in two recent cases, *Williston Basin Interstate Pipeline Co.*¹⁸ and *High Island Offshore System, L.L.C.*¹⁹ Before *Williston II* and *HIOS*, the Commission had required that each company included in the proxy group satisfy the following three standards.²⁰ First, the company's stock must be publicly traded. Second, the company must be recognized as a natural gas company and its stock must be recognized and tracked by an investment information service such as Value Line.

¹⁷ Opinion No. 486, 117 FERC ¶ 61,077 at P 37.

¹⁸ *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036, at P 34-43 (2003) (*Williston II*).

¹⁹ *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, *reh'g denied*, 112 FERC ¶ 61,050 (2005) (*HIOS*).

²⁰ *Id.* at 61,933.

Third, pipeline operations must constitute a high proportion of the company's business. This standard could only be satisfied if a company's pipeline business accounted for, on average, at least 50 percent of a company's assets or operating income over the most recent three-year period.²¹

9. However, in its July 2003 Order in *Williston II*, the Commission found that, because of mergers, acquisitions, and other changes in the natural gas industry, only three corporations remained that satisfied the Commission's historical proxy group standards. Therefore, the Commission relaxed the requirement that natural gas business account for at least 50 percent of the corporation's assets or operating income. Instead, the Commission approved the pipeline's proposal to use a proxy group based on the corporations in the Value Line Investment Survey's list of firms in the "Natural Gas (Diversified) Industry"²² that own Commission-regulated natural gas pipelines, without regard to what portion of the company's business comprises pipeline operations. When the Commission decided *HIOS* in early 2005, the *Williston II* proxy group had shrunk to six corporations. Moreover, the Commission found that two of those corporations, the Williams Companies (Williams) and El Paso Corporation (El Paso), should be excluded from the proxy group on the ground that their financial difficulties had lowered their ROEs to such a low level as to render them unrepresentative.²³ That left the four company proxy group made up of KMI, Equitable, National Fuel, and Questar.

10. In Opinion No. 486, the Commission adopted the same four-company proxy group as it had in *HIOS*. The Commission held that the ALJ erred in failing to exclude Williams and El Paso from the Kern River proxy group. Consistent with *HIOS*, the Commission found that those companies continued to be unrepresentative because of their lower returns and dividend payments.²⁴ In Opinion No. 486, as it had in *HIOS*, the Commission rejected the pipeline's proposal to address the problem of the shrinking proxy group by including MLPs in the proxy group. Kern River asserted that MLPs have a much higher percentage of their business devoted to pipeline operations than most of the corporations eligible for the proxy group under *Williston II*, and therefore are more representative of the risks faced by pipelines. As in *HIOS*,²⁵ Opinion No. 486 concluded

²¹ *Williston II*, 104 FERC ¶ 61,036 at P 35 n.46.

²² See Ex. S-3 at 7.

²³ *HIOS*, 110 FERC ¶ 61,043 at P 118. Opinion No. 486, 117 FERC ¶ 61,077 at P 140-41.

²⁴ *Id.* P 140-41, and n.227-29.

²⁵ *HIOS*, 110 FERC ¶ 61,043 at P 125-26.

that data concerning dividends paid by the proxy group members is a key component in any discounted cash flow (DCF) analysis, and expressed concern that MLP cash distributions may not be comparable to the corporate dividends the Commission uses in its DCF analysis. That was because MLP distributions generally exceed the MLP's reported earnings, and thus include a return *of* invested capital, as well as a return *on* invested capital. By contrast, corporations pay dividends in order to distribute a share of their earnings to stockholders. As such, dividends do not include any return *of* invested capital to the stockholders. Rather, dividends represent solely a return *on* invested capital. For this reason, Opinion No. 486 expressed concern that a DCF analysis based on an MLP's full distribution in excess of earnings, without any adjustment, could lead to a distorted result. The Commission stated that it was not making a generic finding that MLPs could not be considered for inclusion in the proxy group if a proper evidentiary showing is made,²⁶ but stated that any party proposing to include MLPs in a ROE proxy group must establish that the MLP's distributions were equivalent to corporate dividends.²⁷

11. Unlike in *HIOS*, the Commission concluded in Opinion No. 486 that the four corporation proxy group it approved included firms of lower risk than Kern River. The Commission, therefore, added 50 basis points to the median return of the selected proxy group for an equity return of 11.2 percent.²⁸ In contrast, in *HIOS* the Commission set the pipeline's ROE at the median of the four-corporation proxy group based on *HIOS*'s average risk.²⁹

12. There were many requests for rehearing of Opinion No. 486, including those of the ROE determinations by both the shipper parties and Kern River. In its rehearing request, Kern River asserted, among other things, that the Commission had erred in excluding MLPs from the proxy group. It argued that MLPs have a much higher percentage of their business devoted to pipeline operations than most of the corporations eligible for the proxy group under *Williston II*, and therefore are more representative of the risks faced by pipelines.³⁰ It also argued that Opinion No. 486 erred in finding that an

²⁶ Opinion No. 486, 117 FERC ¶ 61,077 at P 149-150. *See also HIOS*, 110 FERC ¶ 61,043 at P 125.

²⁷ This was later revised. *See* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 147.

²⁸ *Id.* P 2.

²⁹ *HIOS*, 110 FERC ¶ 61,043 at P 154, 158.

³⁰ *Id.* P 118; Opinion No. 486, 117 FERC ¶ 61,077 at P 140-41.

MLP's cash distributions in excess of reported earnings could distort the DCF analysis. Kern River made its compliance filing on December 18, 2006.³¹

13. While the requests for rehearing of Opinion No. 486 were pending, the Commission concluded that its proxy group arrangements for both gas and oil pipelines must be reexamined in light of the fact there are so few diversified natural gas companies available for inclusion in the proxy group which may reasonably be considered representative of the risk profile of a natural gas pipeline firm. In addition, there were no publicly traded oil pipeline firms available for the oil pipeline proxy group other than MLPs. Accordingly, on July 17, 2007, the Commission issued a proposed policy statement concerning the composition of the proxy groups used to determine both gas and oil pipeline ROEs.³² The Commission proposed to permit inclusion of MLPs in a ROE proxy group. However, the Commission proposed to cap the "dividend" used in the DCF analysis at the MLP's reported earnings, thus adjusting the amount of the distribution to be included in the DCF model. The Commission left to individual cases the determination of which MLPs and corporations should be included in the proxy group.

14. On August 7, 2007, the Court of Appeals for the D.C. Circuit issued its opinion in *Petal Gas Storage, L.L.C. v. FERC*,³³ reversing the Commission's earlier determinations on the return on equity in *HIOS* and *Petal Gas Storage, L.L.C.*³⁴ Both these appeals turned explicitly on the issue of the relative risk of the proxy group members selected to determine the ROE. The court considered the *Petal* and the *HIOS* appeals together and vacated and remanded the proxy group rulings in both cases. The court emphasized that the Commission's "proxy group arrangements must be risk-appropriate."³⁵ The court further explained that this means that firms included in the proxy group should face similar risks to the pipeline whose ROE is being determined, and any differences in risk

³¹ See *Kern River Gas Transmission Co.*, 119 FERC ¶ 61,106 (2007), which required Kern River to provide its shippers additional information, including computer models, to support its compliance filing.

³² *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 120 FERC ¶ 61,068 (2007) (Proposed Policy Statement).

³³ *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695 (D.C. Cir. 2007) (*Petal v. FERC*).

³⁴ *Petal Gas Storage, L.L.C.*, 97 FERC ¶ 61,097 (2001), *reh'g granted in part and denied in part*, 106 FERC ¶ 61,325 (2004) (*Petal*).

³⁵ *Petal v. FERC*, 496 F.3d 695 at 699 (quoting *Canadian Association of Petroleum Producers v. FERC*, 254 F.3d 289 (D.C. Cir. 2001) (*CAPP v. FERC*)).

should be recognized in determining where to place the pipeline in the proxy group range of reasonable returns. The court recognized that changes in the gas pipeline industry compelled a change in the Commission's traditional approach to determining the proxy group, and the court stated that "controversy about how it should change has been bubbling up in a number of recent cases," citing both *Williston II* and Opinion No. 486. But the court found that the cases on appeal "seem to represent an arrival point of sorts for the Commission," pointing out that Opinion No. 486 had reversed an administrative law judge for deviating from the *HIOS* proxy group.

15. The court held that the Commission had not shown that the proxy group arrangements it approved in *Petal* and *HIOS* were risk-appropriate. The court pointed out that the Commission had rejected the inclusion of MLPs in the proxy group on the ground that MLP distributions, unlike dividends, might provide returns *of* equity as well as returns *on* equity. While stating that this proposition is not "self-evident," the court accepted it for the sake of argument. Nonetheless, the court stated that nothing in the Commission's decision explained why the companies selected by the Commission for inclusion in the proxy group were risk-comparable to *HIOS*. The court stated that when the goal is a proxy group of comparable companies, it is not clear that natural gas companies with highly different risk profiles should be regarded as comparable.³⁶

16. The court further stated that in placing *Petal* and *HIOS* in the middle of the proxy group in terms of return on equity, the Commission expressly relied on the assumption that gas pipelines generally fall into a broad range of average risk compared to other pipelines. However, the court stated, this assumption is decisive only given a proxy group composed of other comparable gas pipelines. The court reasoned that if gas distribution companies generally face lower risk than gas pipelines, a risk-appropriate placement would be at the high end of the group. The court stated that the Commission erred by failing to explain how the proxy group selected reflected the principle of relative risk. Therefore, the court vacated the Commission's orders on the proxy group issue. The court also stated that on remand it did not require any particular proxy group structure, but stated that the overall arrangement must make sense in terms of the relative risk and the statutory command to set just and reasonable rates that are commensurate with returns on investments in other enterprises having corresponding risks.³⁷

17. Thus, in the fall of 2007, the Commission was pursuing its Proposed Policy Statement and the rehearing requests of Opinion No. 486 in the shadow of the *Petal v. FERC* remand. After an initial round of comments and reply comments, the Commission concluded that it required additional comment on the growth rates of MLPs. After notice

³⁶ *Id.* at 700.

³⁷ *Id.*

to that effect and the receipt of an additional round of initial and reply comments, Staff held a technical conference involving an eight member panel on January 23, 2008, which was transcribed for the record. Comments and reply comments were filed thereafter.

18. Subsequently, on April 17, 2008, the Commission issued its Policy Statement concerning the composition of the proxy groups used to determine jurisdictional gas and oil pipelines' ROE under the DCF model.³⁸ The Commission concluded: (1) MLPs could be included in the ROE proxy group for both oil and gas pipelines; (2) there should be no cap on the level of distributions included in the Commission's current DCF methodology; (3) the Institutional Brokers Estimated System (IBES) forecasts would remain the basis for the short-term growth forecast used in the DCF calculation; (4) there should be an adjustment to the long-term growth rate used to calculate the equity cost of capital for an MLP; and (5) there would be no modification to the current respective two-thirds and one-third weightings of the short- and long-term growth factors.

19. The Commission stated that the Policy Statement made no findings as to which particular corporations and/or MLPs should be included in the gas or oil proxy groups. The Commission left that determination to each individual rate case. However, the Commission stated that, in order to assist it in determining the most representative possible proxy group in those cases, the parties and other participants should provide as much information as possible regarding the business activities of each firm they propose to include in the proxy group, including their recent annual SEC filings and investor service analyses of the firms. The Commission also held that the Policy Statement should govern all gas and oil rate proceedings regarding a pipeline's ROE that were pending before the Commission and for which there had not been a final determination.³⁹ The American Public Gas Association (APGA) filed a request for rehearing or reconsideration, which the Commission dismissed on June 13.⁴⁰

20. Contemporaneously with the Policy Statement, the Commission issued Opinion No. 486-A. It denied all requests for rehearing other than those related to the ROE issues.⁴¹ On those issues, Opinion No. 486 granted rehearing to permit the inclusion of

³⁸ Policy Statement, 123 FERC ¶ 61,048.

³⁹ *Id.* P 2.

⁴⁰ *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return On Equity*, 123 FERC ¶ 61,259 (2008). The Commission explicitly stated that the questions raised by APGA could be addressed in individual proceedings with specific reference to the paper hearing in the instant Kern River proceeding. *Id.* P 6 and n.13.

⁴¹ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 1.

MLPs in the proxy group, but denied the Shipper Parties' request to include El Paso and Williams in the proxy group.⁴² Drawing on the extensive public record in the Policy Statement, the instant Kern River proceedings, and the remand decision in *Petal v. FERC*, Opinion No. 486-A reiterated the Policy Statement's conclusions that: (1) MLPs are appropriately included in the proxy group;⁴³ (2) there should be no cap on the distributions to be included in the DCF model;⁴⁴ and (3) long term growth should be limited to 50 percent of gross domestic product (GDP).⁴⁵ Opinion No. 486-A also concluded that there should be no adjustment to the results of the DCF model to reflect the depreciation, the use of external funds, or the income tax advantages of MLPs.⁴⁶

21. Recognizing that the Kern River record did not address all of the issues set forth in the Policy Statement, Opinion No. 486-A reopened the record for a paper hearing in order to give all participants, including Trial Staff, an opportunity to submit additional evidence as to (1) which specific MLPs should be included in the proxy group consistent with the Policy Statement, (2) the appropriate DCF analysis of each entity proposed for inclusion in the proxy group, and (3) where Kern River's ROE should be set in the resulting range of reasonable returns. The Commission stated that, because a primary goal of the new policy is to develop proxy groups made up of a firm whose risk profiles correspond as closely as possible to that of the pipeline whose ROE is being determined, all participants were free to propose whichever MLPs will best accomplish that goal. In addition, parties were permitted to modify their prior positions concerning which corporations to include in the proxy group in light of the addition of MLPs to the proxy group, subject to the Commission's reaffirmation of its ruling that El Paso and Williams must not be included in the proxy group.⁴⁷

22. Only BP requested rehearing of Opinion No. 486-A, focusing primarily on these ROE issues, but also requesting clarification on certain levelized rate issues. During the paper hearing, extensive comments, reply comments, and rebuttal comments were filed

⁴² *Id.* P 188-89.

⁴³ *Id.* P 167-173.

⁴⁴ *Id.* P 174, 178-180.

⁴⁵ *Id.* P 181-183.

⁴⁶ *Id.* P 184-187.

⁴⁷ *Id.* P 167, 188, 190, Ordering Paragraph C.

by all the parties and the Commission's Trial Staff.⁴⁸ On September 30, 2008, Kern River filed a settlement proposal supported by most parties to the proceeding, but opposed by the Trial Staff, BP, and Southwest Gas Corporation (Southwest), and is summarized below.

II. The Settlement Proposal

23. On September 30, 2008, Kern River filed an Offer of Settlement and Stipulation (Settlement) on behalf of the Settling Parties.⁴⁹ On October 8, 2008, Kern River filed work papers supporting the Period One Settlement rates. The Settlement was contested by several parties including BP Energy Company, Southwest Gas Corporation and Trial Staff. As explained further below, the Settlement prohibits severance of issues or parties. The Settlement establishes Kern River's transportation rates for a period of at least five years following the effective date of the Settlement, but reserves certain issues pertaining to Period Two rates for future Commission resolution. The Settlement's resolution of Period One rates would eliminate the need or opportunity for the Commission to resolve the rate of return issues reopened by Opinion No. 486-A. All parties agree that the Settlement provides for a ROE of 12.5 percent. Kern River requests the Commission refrain from issuing an order resolving the paper hearing issues pertaining to ROE pending the Commission's action on the Settlement.

⁴⁸ The active participants were Trial Staff, Kern River, BP, Calpine Energy Services (CES), Kern River, Reliant Energy Services (Reliant), and the Rolled-In Customer Group (RCG). The RCG group includes Area Energy LLC, Anadarko Petroleum Corporation, Anadarko E&P Company, LP, Chevron U.S.A. Inc. (on its on behalf and on behalf of Nevada Cogeneration Associates #1 and Nevada Cogeneration Associates #2), Occidental Energy Marketing, Inc., and Shell Energy North America (formerly Coral Energy Resources, L.P.).

⁴⁹ Settling Parties include the following participants: Kern River; Aera Energy LLC; Allegheny Energy Supply Co., LLC; Anadarko Petroleum Corporation; Anadarko E&P Company, L.P.; Chevron U.S.A. Inc.; El Paso Merchant Energy LP; Occidental Energy Marketing, Inc.; Shell Energy North America; Calpine Energy Services, L.P.; Nevada Cogeneration Associates #1; Nevada Cogeneration Associates #2; Nevada Power Company; Pinnacle West Capital Corporation; Questar Gas Company; High Desert Power Trust; Reliant Energy Services Inc.; Reliant Energy Wholesale Generation, LLC, Southern California Gas Company; Concord Energy LLC; Enserco Energy Inc.; Merrill Lynch Commodities, Inc.; Questar Energy Trading Company; Sacramento Municipal Utilities District; Seneca Resources Corp.; Williams Gas Marketing Inc.; Edison Mission Energy; and the Los Angeles Department of Water and Power.

24. Regarding Kern River's Period One rates, the Settlement establishes transportation rates for Kern River's firm shippers with existing transportation service agreements for the period beginning November 1, 2004 and ending no later than five years from the effective date of the Settlement. Pursuant to the Settlement, all customers would receive the benefits of Period One Settlement rates in the form of refunds, with interest, of any amounts collected in excess of the locked-in Period One rates during the period from November 1, 2004, until the Period One Settlement rates are made effective. The Settling Parties would be eligible for immediate refunds as of October 1, 2008 (subject to recoupment by Kern River in the event the Settlement is not approved). Non-settling parties would not receive refunds pertaining to Period One reduced rates until the Settlement is approved by the Commission. Regarding Kern River's Period Two rates, the Settlement reserves for resolution through litigation or further Settlement the establishment of Period Two (step-down) rates that will apply after expiration of existing mainline shippers' firm transportation service agreements.

A. The Articles of the Settlement

25. Article 1 of the Settlement describes the issues settled and reserved. Article 2 describes the Period One and Period Two rates to be charged. This article describes the rate elements comprising the cost-of-service and Period One rates as well as the annual depreciation and amortization rates. Article 3 describes the obligations of the Settling Parties in the event the Settlement is not approved. This article also describes the negotiated rate agreement between Kern River and High Desert Power Trust. Article 4 addresses the manner in which the Settlement rates will become effective. Appendix D to the Settlement includes revised tariff sheets setting forth the locked-in period rates and the Period One settlement rates. Article 5 sets forth Kern River's refund obligations. This article also provides that Kern River will receive repayment of refunds from the Settling Parties in the event the Settlement is not approved. Article 6 establishes the dates and conditions under which the Period Two rates will be available to shippers upon expiration of their current firm transportation service agreements. Article 7 establishes a five-year moratorium period during which Kern River is precluded from seeking a section 4 rate increase and prohibits all shippers from filing a section 5 complaint to the maximum extent permitted by law during the same five year period.

26. Article 8 explains that the Settlement rates reflect an amount deducted from rate base for the reserve for accumulated deferred federal income taxes for liberalized tax depreciation. Article 9 requires Kern River to file revised tariff sheets to implement the Settlement rates within 10 days after the Settlement becomes effective. Article 10 defines the term of the Settlement. Article 11 describes the procedures by which the Settlement shall become binding on all parties. Article 12 provides that the provisions of the Settlement are not severable. This article provides that if the Commission severs any party or issue from the Settlement, the Settlement is void. Article 13 addresses the procedures attendant to reversal or modification of a final Commission order approving the Settlement on judicial review or after remand. Article 14 establishes that

Commission approval of the Settlement will constitute the necessary authority for Kern River to revise its tariff in order to place Period One Settlement rates into effect and will constitute the final disposition of all issues. This article also provides that Commission approval of the Settlement will terminate the paper hearing established by Opinion No. 486-A with respect to ROE. Article 15 describes the enforcement of the Settlement as subject to the Commission's Natural Gas Act jurisdiction. Article 16 states the Settlement will be legally binding on all parties, is privileged and not admissible in evidence. Article 16 also contains a *Mobile-Sierra* clause providing that the Commission shall apply, to the fullest extent allowed by law, the "public interest" standard to any changes to the Settlement once it has been approved.

27. As noted, as a part of the Settlement, Kern River proposed to immediately place into effect interim rates and provide early refunds for settling parties pending the outcome of the proposed Settlement. Accordingly, Kern River filed tariff sheets set forth in the Appendix to be effective for settling parties for the locked-in period⁵⁰ from November 1, 2004, until the date the Period One rates become effective October 1, 2008. The Appendix also reflects the Period One rates effective October 1, 2008, for settling parties and lists the currently effective motion rates for Kern River's services applied to non-settling parties. Kern River requested the Commission to accept the proposed tariff sheets listed in the Appendix to become effective as proposed. In the event the Settlement is not approved by the Commission, Kern River also proposed it be allowed the right in accordance with section 2 of Article 3 of the Settlement, to recoup from settling parties the refunds Kern River is to pay on October 1, 2008, and/or collect the difference between the locked-in motion rates and the Period One Settlement rates for the interim period. The filing was noticed on October 6, 2008, with comments due on or before October 14, 2008. No adverse comments were filed and the Commission accepted the proposed tariff sheets with one modification by letter order on October 28, 2008.⁵¹

B. Comments

28. Comments and reply comments supporting the Settlement were filed by Kern River, RCG and Calpine Energy Services, L.P. (Calpine). Kern River states that both settling and non-settling parties will receive the Settlement rates and refunds on all amounts collected by Kern River since November 1, 2004, in excess of the locked-in period rates. Kern River also states that the Settlement effectively accepts the Commission's cost-of-service and cost allocation determinations set forth in Opinion

⁵⁰ Kern River has filed numerous tariff sheets for the locked-in period with various effective dates to reflect adjustments pertaining to fuel, annual charge adjustments, and leap year.

⁵¹ 125 FERC ¶ 61,108 (2008).

Nos. 486 and 486-A in this proceeding. Kern River states that the Settlement's pre-tax, overall rate of return of 11.63 percent (1) is below the pre-tax equivalent of the low end of Kern River's DCF proxy ranges;⁵² (2) corresponds with a return on equity of 12.5 percent that is within the range of proxy returns on equity on which the Commission relied in Opinion No. 486;⁵³ and (3) is within the range of returns sponsored by Trial Staff⁵⁴ and by every intervenor that submitted supplemental evidence in the paper hearing established by Opinion No. 486-A.⁵⁵ RCG and Calpine state that the Settlement (1) provides immediate, significant benefits in the form of refunds, lower rates, and rate stability to Kern River's shippers; (2) preserves participants' ability to address Period Two rate issues; and (3) eliminates the need for continued litigation on all other matters.

⁵² Kern River notes that it presented calculations of proxy returns both with and without the MLP Policy Statement's 50 percent adjustment of the GDP growth rate for MLPs. Kern River cites the Supplemental Initial Brief of Kern River Gas Transmission Company in response to Opinion No. 486-A, Docket No. RP04-274-000 at 2 (filed June 17, 2008).

⁵³ Kern River notes that the proxy group the Commission used in Opinion No. 486 produced equity returns ranging from 8.94 percent to 13.62 percent. *See Opinion No. 486*, 123 FERC ¶ 61,056 at P 138. Kern River also notes that calculations similar to those shown in the Appendix to its Initial Comments in Support of the Settlement will confirm that the Settlement's pre-tax return is within the range of pre-tax returns that correspond with this range of equity returns.

⁵⁴ Kern River cites to the Initial Brief of the Commission Trial Staff (Staff Initial Brief) at 3 (filed June 17, 2008). Kern River notes that the median ROEs of Trial Staff's three alternate proxy groups for the 2004 period are 10.35 percent, 10.77 percent, and 10.95 percent, respectively. Kern River also notes that the median ROEs for Trial Staff's two alternative proxy groups for the current period are 11.81 percent and 11.71 percent, respectively.

⁵⁵ Kern River notes the following. Reliant's 2008 proxy group yielded a range of ROEs from 9.25 percent to 12.53 percent, with a median of 11.22 percent (*See Initial Brief of Reliant Energy Services, Inc. (Reliant Initial Brief) at 2 filed June 17, 2008*). The RCG's proxy group produced a range from 8.74 percent to 12.87 percent, with a median of 10.83 percent (*See Initial Brief of RCG in response to Opinion No. 486-A (RCG Initial Brief) at 2 filed June 17, 2008*). BP proposed using its 2004 proxy group, producing a range of returns from 7.31 percent to 13.62 percent, with a median of 9.34 percent (*See Prepared Direct and Answering Testimony of Elizabeth Crowe on behalf of BP Energy Company at 15 (filed December 3, 2004)*; and *Initial Brief of BP Energy on Reopened Record Issues (BP Initial Brief) at 3 (filed June 17, 2008)*).

29. Comments and reply comments opposing the Settlement were filed by BP, Southwest and Trial Staff. BP opposes the Settlement for various reasons. Among other things, BP argues that (1) the Settlement presents genuine issues of material fact; (2) the Settlement limits the NGA section 5 rights of non-consenting parties; (3) the Settlement's cost-of-service is unreasonable; (4) the Settlement is inconsistent with the allocation of risk under Kern River's levelized rate methodology; and (5) the Settlement rates are contrary to the Commission's decision in Opinion No. 486-A, are unjust and unreasonable, and are unduly discriminatory. Southwest argues that the Settlement places restrictions on the availability of Period Two rates. Southwest and Trial Staff argue that the rate moratorium prohibits non-settling parties from initiating action under section 5 of the Natural Gas Act to modify any Settlement rate for five years. Trial Staff believes that the Commission should not impose the Settlement on contesting parties. All three of these parties assert that the 12.5 percent ROE is an unjust and unreasonable part of the settlement rates.

III. Overview of the Commission's Rulings in this Order

30. In this order, the Commission (1) finds, based on the record established through the paper hearing, that Kern River's ROE should be 11.55 percent, (2) rejects the settlement, and (3) denies BP's request for rehearing on all issues, except for a clarification concerning the design of Kern River's Period Two levelized rates.

31. In order to approve the Settlement, the Commission would have to find that the Settlement rates are just and reasonable. That is because the settlement is contested by two current shippers on Kern River's system and the settlement expressly prohibits the severance of contesting parties. While the settlement is described as a black-box settlement, Kern River and the other supporting parties assert that the settlement rates include an ROE of about 12.5 percent and are otherwise consistent with all of the non-ROE merits rulings of Opinion Nos. 486 and 486-A. Therefore, approval the Settlement would require a finding that awarding Kern River an ROE of 12.5 percent is just and reasonable.

32. Accordingly, this order first addresses the parties' contentions concerning Kern River's ROE. For the reasons discussed below, the Commission (1) denies BP's contention on rehearing of Opinion No. 486-A that the Commission should not apply the Policy Statement in this proceeding, (2) approves a five member proxy group including two corporations and three MLPs based on the paper hearing record, (3) finds that the median ROE of that proxy group is 11.55 percent, and (4) finds that Kern River is a pipeline of average risk and therefore its ROE should be set at the median of the proxy group.

33. Based on this holding concerning Kern River's ROE, the Commission then addresses the parties' contentions concerning the settlement. The Commission finds that the parties supporting the settlement have not shown that the settlement provides

sufficient offsetting benefits to justify imposing on the contesting parties settlement rates reflecting an excessive ROE. Therefore, in light of the settlement's provision that contesting parties may not be severed, the Commission must reject the settlement.

34. Finally, the Commission generally denies BP's request for rehearing concerning Kern River's Periods Two and Three levelized rates, but does grant one clarification.

IV. Application of Proxy Group Policy Statement and the Establishment of the Paper Hearing on ROE

35. Before reaching the merits of the ROE issue, we first address several procedural issues raised by BP. In its request for rehearing of the Opinion No. 486-A, BP argues that the Commission (1) incorrectly applied the Policy Statement retroactively to the instant Kern River proceeding, (2) improperly afforded Kern River another opportunity to supplement its ROE case, (3) unlawfully relied on extra record evidence for some of its conclusions, and (4) improperly relied on *Petal* to justify the paper hearing and developing a further record.

36. The Commission rejects these contentions. While it is true that a policy statement is a guide to future behavior, there is no inconsistency between that precept and Opinion No. 486-A's decision to apply the Policy Statement in this proceeding. As the background section of this order makes clear, the issue of whether MLPs should be included in Kern River's proxy group was squarely before the Commission on rehearing at the time the Policy Statement issued. Thus, the future action at issue in Opinion No. 486-A was the policy to be applied to Kern River's request for rehearing of the prior determination rejecting Kern River's proposed inclusion of MLPs in the proxy group. At bottom, BP argues that once a proceeding begins, a policy statement may only be applied to cases for which the Commission has not issued some form of a merits decision.

37. However, the law is otherwise. In *Williston v. FERC*,⁵⁶ the Commission changed its policy on the weighting of the short- and long term growth components of the DCF model while the pipeline's appeal of a Commission order determining its ROE based on the old policy was pending before the court. The court found that the Commission's change in policy might entitle the pipeline to a recalculation of its ROE, and remanded the case to the Commission to consider whether to apply the new policy. On remand, the Commission applied its new policy and awarded the pipeline a somewhat increased

⁵⁶ See *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54 (D.C. Cir. 1999) (*Williston v. FERC*).

ROE.⁵⁷ Similarly, in *Panhandle Eastern*,⁵⁸ the court had remanded the case subsequent to a change in Commission policy. Therefore the issue had remained open and the Commission applied the new policy to the remanded proceeding.⁵⁹ Thus, contrary to BP's argument, both the cited cases followed the rule that the Commission usually applies current policy when it decides an issue still before it.

38. It is true that in another case, *Consolidated Edison*, the court held the Commission can decline to apply a new policy to an open issue provided it has adequate reasons for doing so, and providing that the old policy was not unreasonable or unlawful.⁶⁰ In that case the record was some four years old and the Commission concluded it should remain closed for reasons of administrative efficiency. In the instant case, however, such an approach is not possible, because the Commission has determined that the proxy group policy applied in Opinion No. 486 was unreasonable.

39. Opinion No. 486 adopted an ROE for Kern River using exactly the same proxy group as was used in *HIOS*, and Opinion No. 486 rejected the inclusion of MLPs in the proxy group based on essentially the same reasoning as in *HIOS*.⁶¹ Based upon an initial review of the requests for rehearing of Opinion No. 486, as well as developments in the gas and oil pipeline industries generally, the Commission concluded that its proxy group arrangements for both gas and oil pipelines must be reexamined, because there are so few reasonably representative corporations available for inclusion the proxy group. Because any change in its proxy group policies would affect the natural gas and oil pipeline industries generally, the Commission determined to address the issue first in a generic proceeding in which all affected parties in both industries could participate. Accordingly, as described above, the Commission issued a proposed policy statement, proposing to change its proxy group policies for both natural gas and oil pipelines. Shortly after issuance of the proposed policy statement, the D.C. Circuit issued its decision in *Petal v. FERC*, vacating and remanding the Commission's proxy group holdings in *HIOS*, and the court expressly observed that Opinion No. 486 had adopted the *HIOS* proxy group.

40. Accordingly, the Policy Statement reviewed the Commission's prior conclusions regarding the inclusion of MLPs in a ROE proxy group in light of the court's decision in

⁵⁷ See *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,265 (1999).

⁵⁸ *Panhandle Eastern Pipeline Co. v. FERC*, 890 F.2d 435 (D.C. Cir. 1989).

⁵⁹ *Panhandle Eastern Pipeline Co.*, 52 FERC ¶ 61,127 (1990).

⁶⁰ *Consolidated Edison Co. of N.Y. v. FERC*, 315 F.3d (D.C. Cir 2003).

⁶¹ Opinion No. 486, 111 FERC ¶ 61,077 at P 138-140, 142.

Petal v. FERC. While BP is correct that the court left open the possibility that the Commission could continue the *HIOS* proxy arrangements, if it could explain and justify them “in very different terms,”⁶² the Commission concluded in the Policy Statement that it must change its proxy group policies in order to address the court’s concerns.⁶³ Among other things, the Commission found that its prior analysis in *HIOS* and Opinion No. 486 of why including MLPs in the proxy group without adjusting their cash distributions would lead to distorted results and was inconsistent with the basic structure of a DCF model and therefore was unreasonable.⁶⁴ Because the Commission has found it could not support its proxy group holdings in *HIOS* and Opinion No. 486 and adopted a revised proxy group policy in the Policy Statement, it must apply the new policy in this proceeding.

41. Thus, regarding BP’s second argument, it was not inequitable to afford Kern River and the other participants in this case another opportunity to address the ROE issues in light of the Commission’s revised proxy group policies, nor should Kern River be required to file a new section 4 rate case as BP urges. While Kern River advanced various theories supporting the inclusion of MLPs in the proxy group in the evidentiary phase of this proceeding and on rehearing, those are subsumed under the Commission’s holding that those matters must be revisited. Thus BP’s argument that the Commission had previously rejected the use of MLPs in Kern River’s proxy group is untenable. BP similarly argues that affording Kern River an opportunity to supplement the record violates the latter’s obligation to prove its rates are just and reasonable, to provide all required evidence in its initial case in chief, and is inconsistent with the Commission’s rejection of Kern River’s earlier efforts to reopen the record. These arguments are specious given *Williston* and the Commission’s authority to control its proceedings.

42. BP’s third procedural argument is that the Commission acted unlawfully in relying in part on materials outside the record, specifically those included in the record of the Policy Statement. This is incorrect. In an analogous situation the Commission issued a notice of inquiry regarding income tax allowances on December 2, 2004.⁶⁵ Following extensive initial and reply comments, the Commission issued its Policy Statement on Income Tax Allowances on May 4, 2005.⁶⁶ The Commission then reprised the Income

⁶² *Petal v. FERC*, 496 F.3d at 696.

⁶³ Policy Statement, 123 FERC ¶ 61,048 at P 47-51.

⁶⁴ *Id.* P 47-63.

⁶⁵ *Inquiry Regarding Income Tax Allowances* in Docket No. PL05-5-000.

⁶⁶ See *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (Income Tax Policy Statement).

Tax Policy Statement in detail in *SFPP, L.P.* and made detailed findings expressly grounded in the record of the Income Tax Policy Statement record.⁶⁷ On appeal, in *ExxonMobil Oil Corporation v. FERC*,⁶⁸ the court upheld the application of the Income Tax Policy Statement based on its review of the record the Commission had developed in the income tax allowance policy proceeding.⁶⁹ Opinion No. 486-A used the same approach by addressing certain fundamental issues on an extensive record following that model. Moreover, this complaint is moot because the Commission has afforded a further opportunity for comment on the financial issues discussed in the Policy Statement.

43. BP's fourth criticism is that Opinion No. 486-A erred in holding the MLPs could be included in the Kern River proxy group.⁷⁰ However, as BP itself states, the Policy Statement reserved to specific proceedings the determination of which MLPs, if any, were representative of pipeline operations, and as such, are comparable to the risk of the pipeline whose rates are at issue.⁷¹ Thus, the Commission did not conclude that MLPs must always be included in a proxy group, much less that it is appropriate in the instant case. Moreover, the Commission did not exclude from the proxy group all diversified natural gas corporations.⁷² The Policy Statement did reconsider the Commission's prior reservations concerning the use of MLPs in a ROE proxy group, and concluded the Commission could reasonably permit the use of MLPs in ROE proxy groups.⁷³ However,

⁶⁷ *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) (the Remand Order).

⁶⁸ *ExxonMobil Oil Corporation v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) (*ExxonMobil*).

⁶⁹ *Id.* at 950-52. The court explicitly stated that:

"However, in the Remand Order -- which is challenged in the instant case -- the Commission expressly relied on the conclusions and reasoning of the Policy Statement.... Thus, in determining whether the Remand Order was arbitrary or capricious or contract to *BP West Coast*, we necessarily review the Commission's conclusions and reasoning in the Policy Statement." *Id.* 951.

⁷⁰ As discussed below, in its paper hearing filings, BP includes at least three MLPs in its proposed proxy group.

⁷¹ Policy Statement, 123 FERC ¶ 61,048 at P 51 (*citing Petal v. FERC* at P 50).

⁷² Opinion No. 486-A, 123 FERC ¶ 61,056 at P 167, 188, 190, Ordering Paragraph (C); *Id.*

⁷³ *Id.* P 172, 175-76.

the Commission established a paper hearing in this case precisely to determine on a case specific record what entities of any type should be included in the proxy group.

44. The Commission thus rejects BP's contentions that the Commission should decide the ROE issues in this case based on its policies as in effect before the Policy Statement and that the Commission therefore should not have reopened the record. The Commission will address BP's other contentions in its rehearing request contesting certain aspects of proxy group policies adopted in the Policy Statement in the next section of this order.

V. Merits Determinations on the ROE Issues

45. Having disposed of BP's various procedural arguments, we now turn to the merits of the ROE issue. As discussed in the Policy Statement, the Supreme Court has held that "the return to the equity owner should be commensurate with the return on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."⁷⁴ In order to attract capital, "a utility must offer a risk-adjusted expected rate of return sufficient to attract investors."⁷⁵ In theory, this requires an evaluation of the regulated firm's needed return compared to other regulated firms of comparable risk.

46. However, most natural gas pipelines are wholly-owned subsidiaries and their common stock is not publicly traded. Therefore, the Commission performs a DCF analysis of publicly-traded proxy firms to determine the return the equity markets require a pipeline to give its investors in order for them to invest their capital in the pipeline. The DCF model is based on the premise that "a stock's price is equal to the present value of the infinite stream of expected dividends discounted at a market rate commensurate with the stock's risk."⁷⁶ With simplifying assumptions, the DCF model results in the investor using the following formula to determine share price:

$$P = D / (r-g)$$

⁷⁴ *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

⁷⁵ *CAPP v. FERC*, 254 F.3d 289 at 293.

⁷⁶ *Id.*

where P is the price of the stock at the relevant time, D is the current dividend, r is the discount rate or rate of return, and g is the expected constant growth in dividend income to be reflected in capital appreciation.⁷⁷

47. Unlike investors, the Commission uses the DCF model to determine the ROE (the “r” component) to be included in the pipeline’s rates, rather than to estimate a stock’s value. Therefore, the Commission solves the DCF formula for the discount rate, which represents the rate of return that an investor requires in order to invest in a firm. Under the resulting DCF formula, ROE equals current dividend yield (dividends divided by share price) plus the projected future growth rate of dividends:

$$R = D/P + g$$

48. The Commission uses a two-step procedure for determining the constant growth of dividends: averaging short-term and long-term growth estimates. Security analysts’ five-year forecasts for each company in the proxy group (discussed below), as published by IBES, are used for determining growth for the short term; long-term growth is based on forecasts of long-term growth of the economy as a whole, as reflected in the GDP.⁷⁸ The short-term forecast receives a two-thirds weighting and the long-term forecast receives a one-third weighting in calculating the growth rate in the DCF model.⁷⁹

49. The submissions of the parties in the paper hearing focus on the issues of the selection of the proxy group and Kern River’s relative risk compared to the potential proxy firms. However, the parties have also addressed various other issues concerning the determination of the ROE to be awarded Kern River. In response, this portion of the order addresses four general topics: (1) the composition of the proxy group; (2) the determination of the dividend yield of the proxy firms; (3) the growth rates of the proxy firms; and (4) the relative position of Kern River within the selected proxy group.

⁷⁷ *National Fuel Gas Supply Corp.*, 51 FERC ¶ 61,122, at 61,337, n.68 (1990); *Ozark Gas Transmission System*, 68 FERC ¶ 61,032, at 61,104, n.16. (1994).

⁷⁸ *Northwest Pipeline Company*, 79 FERC ¶ 61,309, at 62,383 (1997) (*Opinion No. 396-B*). *Williston Basin Interstate Pipeline Company*, 79 FERC ¶ 61,311, at 62,389 (1997) (*Williston I*), *aff’d in relevant part, Williston v. FERC*, 165 F.3d at 57.

⁷⁹ *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶ 61,084 at 61,423-4 (*Opinion No. 414-A*), *reh’g denied*, 85 FERC ¶ 61,323, at 62,266-70 (1998) (*Opinion No. 414-B*), *aff’d, CAPP v. FERC*, 254 F.3d 289 (D.C. Cir. 2001).

A. Composition of the Proxy Group

50. As the court explained in *Petal v. FERC*, the purpose of the proxy group is to “provide market-determined stock and dividend figures from public companies comparable to a target company for which those figures are unavailable. Market-determined stock figures reflect a company’s risk level and when combined with dividend values, permit calculation of the ‘risk-adjusted expected rate of return sufficient to attract investors.’”⁸⁰ It is thus crucial that the firms in the proxy group be comparable to the regulated firm whose rate is being determined. In other words, as the court emphasized in *Petal v. FERC*, the proxy group must be “risk-appropriate.”⁸¹

51. However, given the numerous factors that can vary the risk profile of the individual firm, it is difficult in an individual case to develop a proxy group of sufficient numbers in which the members will have exactly the same risk. In the instant case, 100 percent of Kern River’s assets, revenues, and earnings are derived from its interstate gas transmission pipeline function. Given this level of natural gas pipeline activity, it is unlikely there will be complete congruence among the characteristics of all proxy group members. For this reason, as both BP and Staff assert, *Petal* requires a full and complete analysis of the similarities and differences between the business activities of each of the proposed proxy firms and Kern River in order to ensure that the operations presented by the proxy group companies adopted are analogous to Kern River’s operations and risks.

52. The paper hearing participants propose a range of proxy group members for both a 2004 and 2007-2008 proxy group. Staff proposes three different groups for the year 2004, one of four members and two of five members. After eliminating a number of firms Staff concluded were inappropriate, Staff’s 2004 proxy group included KMI, National Fuel, Northern Border Partners, L.P. (Northern Border), Questar, and TC Pipelines, L.P. (TC Pipelines). For the year 2008 Staff proposed two proxy groups consisting of six and seven members and added the following to the 2004 group: Enterprise Products Partners, L.P. (Enterprise), Equitable, Kinder Morgan Energy Partners, LP (KMEP), Oneok Partners (Oneok, formerly Northern Border), and Southern Union Company (Southern Union), but deleted KMI.⁸² BP proposes a nine member group for the year 2004: Equitable, KMEP, KMI, National Fuel, NiSource, Inc. (NiSource), Oneok Partners, L.P. (Oneok, meaning Northern Border in that year),

⁸⁰ *Petal v. FERC*, 496 F.3d at 697 (quoting *CAPP v. FERC*, 254 F.3d 289 at 293).

⁸¹ *Id.*

⁸² Initial Brief of the Commission Trial Staff (Staff Initial Brief), Ex. S-2 at Schedules 1-3 and 7-9.

Questar, Southern Union, and TC Pipelines.⁸³ BP also proposes an eleven member group for the year 2008 that added Boardwalk Partners (Boardwalk), Spectra Energy Partners, L.P. (Spectra Partners), Spectra Energy Corporation (Spectra Energy), and deleted KMI.⁸⁴ Kern River proposed a four firm sample for the 2004 test year, consisting of Enterprise, KMI, KMEP, and Northern Border, and no proxy group for the year 2008.⁸⁵

53. RCG proposed seven members for the year 2008 consisting of Southern Union, Spectra Energy, TC Pipelines, KMEP, TransCanada Corporation (TransCanada), Oneok, and Boardwalk⁸⁶ and later a 2004 group consisting of Equitable, KMI, National Fuel, Questar, TransCanada, Enterprise, and Northern Border. Reliant proposed a three member group for the year 2004 consisting of KMI, Northern Border, and TC Pipelines⁸⁷ and a five member sample group for the year 2008 that deleted KMI and added Boardwalk, Southern Union, and Spectra Energy.⁸⁸ Staff, Reliant, and BP proposed using a 2004 or 2008 test year with BP favoring 2004, Reliant 2008, and Staff asserting that either was acceptable. Kern River asserted that only the year 2004 is appropriate with RCG first proposing a 2004 test year, but later accepting a 2008 test year as well.

1. The Test Year for This Proceeding

54. This order now addresses the threshold issue of whether the proxy group should be determined based on proxy company data for (1) the 2004 test period upon which Kern River's rates in this rate case are based⁸⁹ or (2) updated data for 2008. Opinion No. 486 was based on a 2004 test year. At this juncture, Kern River and Calpine assert that the Commission should retain the 2004 test year. Reliant, BP, and Staff provide proposed proxy groups and DCF analyses for the years 2004 and 2008. RCG first included only a year 2008 proxy group but later devised one for 2004 as well.

⁸³ BP Initial Brief at 3.

⁸⁴ *Id.* at 4

⁸⁵ Supplemental Initial Brief of Kern River Transmission Company in Response to Opinion No. 496-A (Kern River Initial Brief) at 1, 6-10.

⁸⁶ RCG Initial Brief at 2, 11-13.

⁸⁷ Reply Brief of RCG in Response to Opinion No. 486-A (RCG Reply Brief) at 5.

⁸⁸ Reliant Initial Brief at 1, 6-7.

⁸⁹ The last twelve months of the test period in this rate case was the year ending on October 31, 2004. For convenience, in this order we shall refer to that period as "the 2004 test year."

55. The parties advancing the use of the 2008 test year argue that nothing in Opinion No. 486-A precludes the use of a 2008 test year, and that in fact the Commission reopened the record in that time frame. Staff further argues that even in gas cases the Commission has a longstanding policy to consider updated financial data beyond the test period when circumstances warrant. While Staff takes no definite position, it suggests that the Commission could establish one equity cost of capital for the period November 1, 2004 through April 17, 2008, and a second thereafter.⁹⁰ BP states that there are synchronization and consistency issues if the year 2008 is used and believes that the year 2004 is the better year.⁹¹ Reliant and RCG assert that the year 2008 is the better year because it more accurately reflects economic conditions for the time frame the rates will be in effect. They place particular emphasis on continued growth in Kern River's throughput after 2004, its stronger contractual position in 2008, and the improved prospects for production in the gas basins it serves. They use this evidence to bolster their argument that Kern River is materially less risky than other gas pipelines and should be placed at the lower end of the zone. They argue that the more recent 2008 throughput data establishes that Kern is significantly over recovering its 2004 cost of service.⁹²

56. Kern River argues that the year 2008 does not reflect the elements in its cost of service or its risk in that year. It also asserts that many of the firms proposed for the 2008 proxy group did not even exist in 2004 and it is hard to see how the risks of those firms in 2008 could possibly be comparable to the conditions Kern River faced in 2004. Kern River further argues that the additional information regarding volumes and its more recent prospects is wholly inconsistent with the Commission's test period concept. It requests the Commission to exclude all 2008 evidence from the record.⁹³

57. The Commission will retain the 2004 test year. All other aspects of Kern River's rates are being established based on data from that time frame, and therefore Kern River's rates should also reflect its capital costs at that time. Kern River's capital cost is the weighted cost of its debt and equity capital structure. The only debt information here is for the year 2004. Thus, if the Commission were to use a 2008 proxy group, it would have to combine a 2004 debt cost with a 2008 equity cost, which distorts the overall weighted cost of capital. Moreover, equity cost is directly related to the cost of debt

⁹⁰ Citing *Williston Basin Interstate Pipeline Company*, 72 FERC ¶ 61,075, at 61,373 (1995).

⁹¹ BP Initial Brief at 4.

⁹² RGC Initial Brief at 7-9; Reliant Initial Brief at 5-6 and 15-16.

⁹³ Reply Brief of Kern River Transmission Company in Response to Opinion No. 486-A (Kern River Reply Brief) at 2-4 and 7-11.

because it reflects in part a markup over debt cost based on the risk of the firm in the same period. Thus, it is internally inconsistent to use debt and equity costs from different periods. Finally, the Commission concludes that RCG and Reliant's use of post-2004 increases in Kern River's throughput to justify a 2008 proxy group is generally inconsistent with the 2004 test period and serves to highlight the lack of synchronization between a cost of service and operating profile grounded in 2004 data and a risk profile based on the year 2008. As Kern River points out, some of the firms relied on for the 2008 proxy group did not even exist in 2004 and as such may not have had a risk profile similar to that of Kern River.⁹⁴

58. This order now turns to an analysis of the firms the parties proposed to include in the proxy group based on data for the year 2004. These firms fall into three categories. These are (1) corporations historically recognized as predominantly engaged in the interstate natural gas transmission business; (2) MLPs owning natural gas transmission companies; and (3) diversified natural gas companies with some interstate natural gas transmission business but with a majority of the business in other natural gas activities such as distribution and exploration and production.

2. Gas Pipeline Transmission Corporations

59. As described above, the Commission historically required that a proxy firm's pipeline business account for, on average, at least 50 percent of the firm's assets or operating income over the most recent three-year period. The possible sample of gas pipeline corporations which satisfy that standard is limited, because El Paso and Williams, two traditional gas transmission companies, are excluded from the 2004 proxy group for the reasons stated in Opinion No. 486. The remaining corporations which satisfy this standard, discussed by the parties, are KMI and TransCanada Corporation. As of the end of 2004, KMI's ownership of Natural Gas Pipeline Company of America (Natural) accounted for 55 percent of its assets.⁹⁵ In addition, its investment in KMEP accounted for another 23 percent of its assets. As discussed further below, about 35 percent of KMEP's assets are natural gas pipeline facilities. Thus, KMI's pipeline business accounts for over 60 percent of its assets. All the parties accept KMI as an appropriate interstate gas transmission firm given its predominance of interstate gas pipeline operations. Therefore KMI will be included in the Kern River proxy group.

⁹⁴ Rebuttal Brief of Kern River Transmission Company in Response to Opinion No. 486-A (Kern River Rebuttal Brief) at 8.

⁹⁵ Ex. S-3 at 31.

60. Approximately 91 percent of TransCanada's operating income is from its natural gas pipeline business.⁹⁶ However, all the parties except RCG oppose its inclusion in the proxy group, because it was involved in a nearly two billion dollar acquisition of Gas Transmission Northwest in 2004, which could distort its stock price and dividend yield.⁹⁷ Also, TransCanada's Canadian pipeline is subject to a significantly different regulatory structure that renders it less comparable to domestic pipelines regulated by the Commission.⁹⁸ For these reasons, TransCanada will be excluded from the proxy group.

3. MLPs Owning Transmission Companies

61. Various parties suggest four MLPs owning different types of transmission companies for inclusion in the proxy group. The four MLPs are Northern Border, TC Pipelines, KMEP, and Enterprise. Of these, Northern Border and TC Pipelines had gas transmission assets and/or operating income in excess of fifty percent in 2004. The other two MLPs do not satisfy the fifty percent standard, but nevertheless are supported by certain parties. For the reasons discussed below, the Commission includes Northern Border, TC Pipelines, and KMEP in the proxy group, but excludes Enterprise.

a. Northern Border and TC Pipelines

62. During 2004, 91 percent of Northern Border's operating income came from interstate natural gas pipeline operations, with the remainder from gathering and processing.⁹⁹ While Northern Border was not followed by Value Line, it was publicly traded and IBES did report on it, including providing a five-year growth projection. All the parties support including Northern Border in the proxy group, and accordingly, the Commission will do so.

63. TC Pipelines is an investment partnership, which in 2004 owned a 30 percent interest in Northern Border Pipeline Co. and a 49.1 percent interest in Tuscarora Gas

⁹⁶ Ex. S-2, Schedule 3.

⁹⁷ *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279, at 61,932-33 (2000).

⁹⁸ Staff Initial Brief at 8; Staff Reply Brief at 13; Kern River Rebuttal Brief at 14. Value Line recognizes this difference by categorizing TransCanada as among the firms in the "Canadian Energy Industry," and not the firms in the "Natural Gas (Diversified) Industry." Ex. S-3 at 7.

⁹⁹ See Ex. S-2 at Schedule 2. In 2004, Northern Border held a 70 percent interest in Northern Border Pipeline Co., a 100 percent interest in Viking Gas Transmission Co. and Midwestern Gas Transmission Co., and a 33 percent interest in Guardian Pipeline Co. Ex. BP-150 at 1.

Transmission Co.¹⁰⁰ All of TC Pipeline's 2004 revenue came from dividends paid by those two pipelines. While TC Pipelines is not included in Value Line's list of diversified natural gas companies, it is followed by both Value Line and IBES.

64. Staff, BP, and RCG suggest that TC Pipelines could be a member of a 2004 proxy group. However, Kern River would exclude TC Pipelines from the 2004 proxy group as it has no pipeline operations of its own, is too small to be representative, and was not listed in the major edition of Value Line in 2004 even though all of its revenue derives from gas transmission.

65. The Commission concludes that TC Pipelines is an investment partnership that owned large minority interests in two major interstate natural gas pipelines in 2004 and all of whose revenue came from the dividends of those pipelines. It is true that it owned no pipeline assets of its own, and no credit ratings are included in the record. However, despite its small size, TC Pipelines was a publicly traded company on the New York Stock Exchange, was listed in the secondary or minor Value Line analysis in 2004,¹⁰¹ and made distributions to its unit holders out of the dividends received from the pipelines in which it invested. Consistent with (1) the premise underlying the DCF methodology that a stock's price is equal to the present value of its future cash flows and (2) the fact that all of the cash flows from an investment in TC Pipelines derive from the gas transmission business, investors in TC Pipelines must view its risk profile as the same as that of the natural gas pipelines in which TC Pipelines invests. Thus, its unit price, cash distributions, and growth prospects are all tied to the health of the gas transmission business. In fact, Kern River's own witness conceded that TC Pipelines "was, and still is, a gas transmission play."¹⁰²

66. Given the small number of firms available for inclusion in the proxy group for the year 2004, the Commission concludes that TC Pipelines should be included due to its predominately natural gas pipeline profile and its publicly traded status. This satisfies two of the Commission's traditional standards, the two more important for performing a representative DCF calculation, and comes close on the third, a listing in Value Line, in 2004. While it was not listed in the major edition of Value Line, it was reported on.¹⁰³

¹⁰⁰ Ex. BP-150 at 1.

¹⁰¹ Ex. No. RES-16 at 12-14.

¹⁰² Ex. KR-132 at 13.

¹⁰³ Reply Brief of Reliant Energy Services (Reliant Rely Brief) at 12, n.9, *citing* Ex. No. RES-16 at 15.

The first assures that the company is representative of the industry and the second that the necessary trading and return information is available. The fact that TC Pipelines is relatively small can be addressed by evaluating its relative risk within the proxy group.

b. Kmep

67. KMEP is an MLP included in Value Line's list of diversified natural gas companies. KMI is its general partner. In 2004, KMEP owned 100 percent interests in two interstate natural gas pipelines, Kinder Morgan Interstate Transmission, Inc., and Trailblazer Pipeline Co.¹⁰⁴ In addition, effective November 1, 2004, KMI transferred its 100 percent ownership interest in TransColorado Gas Transmission Co. to KMEP.¹⁰⁵ According to Standard & Poors Ratings Direct (S&P) data provided by Trial Staff, KMEP's natural gas pipelines accounted for 35 percent of its total assets as of the end of 2004.¹⁰⁶ KMEP also owned oil and product pipelines which accounted for another 35 percent of its assets, CO2 pipelines which accounted for 14 percent of its assets, and terminal facilities which accounted for the remaining 15 percent.¹⁰⁷ The S&P 2004 operating income data for KMEP is distorted by a negative corporate overhead charge of 45 percent. However, similar to the distribution of its assets, KMEP had approximately equal amounts of operating income from its natural gas pipelines and from its oil pipelines and its income from CO2 pipelines and terminals was about half the amount from its gas and oil pipelines.¹⁰⁸ KMEP was not involved in any gas distribution, exploration and production, or trading and marketing activities during 2004.

68. Kern River and BP both propose to include KMEP in the proxy group, but Trial Staff and the other parties do not. Several parties raise two concerns regarding the inclusion of KMEP in the proxy group, one based on its affiliate status with KMI and the second that some 35 percent of its operating income involves oil and product pipelines. Regarding the first concern, Trial Staff asserts that a MLP that has the same assets as a corporation parent should be excluded from the proxy group because including both firms

¹⁰⁴ BP Ex. No. 178.

¹⁰⁵ Ex. S-3 at 33.

¹⁰⁶ *Id.* at 36.

¹⁰⁷ *Id.*

¹⁰⁸ According to Kern River's analysis of KMEP's 2004 SEC Form 10-K, KMEP obtained 30 percent of its earnings from natural gas pipelines, 31 percent from petroleum pipelines, 20 percent from terminals, and 19 percent from CO2 pipelines. Ex. KR-133 at 2.

double counts the assets and the income. It asserts this would count the cost of capital twice and would overweight the proxy group toward the equity cost of capital of those particular firms. Trial Staff also asserts that the cost of capital for KMI and KMEP is quite close, which indicates they have duplicating assets.¹⁰⁹

69. In response, Kern River asserts that the two firms have different assets even if they have some similar assets that are owned by different firms. It also argues that the two firms have separately traded public securities and present options to investors. Specifically, KMEP is an MLP that places greater emphasis on distributions and less on growth. KMI is a corporation that places more emphasis on growth and less on current dividends. Thus, they are different firms with different investment profiles despite their interlocking financial interests.¹¹⁰

70. The Commission finds that KMI and KMEP represent sufficiently separate investments that both may be included in the proxy group. As of the end of 2004, KMI's investment in KMEP represented only 23 percent of its assets. In addition to its investment in KMEP, KMI also owned 100 percent of Natural, which represented 55 percent of its assets.¹¹¹ Thus, KMI's investment in KMEP represented less than one quarter of its assets, and a substantial part of its gas transmission business is unrelated to KMEP. As Kern River points out, KMI and KMEP are separately traded public securities. Given that KMI's business operations include substantial natural gas transmission and other business activities in which KMEP is not involved, the two stocks do not represent investments in the same business. That the investment community views the two stocks as separate and distinct investments is demonstrated by the fact that security analysts surveyed by IBES in 2004 projected significantly greater growth for KMI than for KMEP.

71. Moreover, KMEP's asset and earnings profile includes a products pipeline component equal to its natural gas pipeline component, and secondary CO₂ pipeline and terminal components of equal weight. All three of these non-natural gas pipeline components have a somewhat higher risk than the natural gas pipeline component of the firm. As such, Trial Staff's assertion that the two firms have similar risks because they

¹⁰⁹ Ex. S-6 at 4.

¹¹⁰ Kern River Reply Brief at 14-15 and Ex. No. KR-138 at 8; Kern River Rebuttal Brief at 14 and Ex. No. KR-139 at 16.

¹¹¹ According to Kern River, 39 percent of KMI's 2004 earnings were from Natural and TransColorado (prior to its November 1, 2004 transfer to KMEP), and 7 percent from the gas distribution business of Kinder Morgan Retail, while 53 percent were from KMEP. Ex. KR-133 at 4.

have similar returns may mean that they have similar risks and returns because they have similar assets, not that they have the same assets. In fact, the analysis here would suggest that KMEP's risk is somewhat higher. This would be reflected to a degree in KMI's risk, but KMI would have less risk given its predominance of gas pipeline assets.

72. Thus, while KMEP's risk would be reflected in KMI's return, stock price, and financial ratings, the two firms offer different investment opportunities and ownership characteristics. KMEP and KMI are sufficiently distinct that KMI's partnership interest in KMEP does not require exclusion of KMEP from the proxy group given the instant facts.¹¹²

73. The second objection to including KMEP in the proxy group is the fact that a significant part of its business in 2004 was the oil pipeline business and therefore it should not be classified as a gas transmission firm because oil and product pipelines have different risks than natural gas pipelines. As Trial Staff notes, the Commission has traditionally considered oil pipelines to be somewhat more risky than natural gas pipelines. The principal reason is that oil pipelines frequently operate in markets where oil can be delivered by competing pipelines, or by barge for longer movements and by trucks from terminals for shorter movements. Oil pipelines must charge common carrier rates that are equal for all customers shipping between the same points. They thus have fewer opportunities to discount within the wider price range available to gas pipelines provided by the latter's ability to contract with individual customers. In contrast, BP asserts here that oil pipelines have no barriers to entry or exit and can recover cost increases through an indexing mechanism that reduces regulatory risk.¹¹³ BP also asserts that the increased demand for the transportation of petroleum products since 2000 may have also reduced the market risk of many petroleum and product pipelines. It therefore concludes that oil pipelines are actually less risky than many, if not most, interstate gas pipelines.

74. As noted, Trial Staff's 2004 analysis concludes that KMEP's operations, based on asset allocations to eliminate accounting distortions, were 35 percent gas transmission, 35 percent oil products, and 30 percent other.¹¹⁴ The duality of the firm's operations is also reflected by the inclusion of KMEP in that year as part of Value Line's Natural Gas (Diversified) Group. In a later year KMEP became a member of a broad group that included both gas and oil transmission firms. As recently stated by Value Line:

¹¹² See RCG Initial Brief at 12-13.

¹¹³ Rebuttal Brief of BP Energy Company on Reopened Record Issues (BP Rebuttal Brief) at 19.

¹¹⁴ Ex. S-3 at 36.

The Oil/Gas Distribution Industry is unusually homogeneous in its operations as members do little besides distribute hydrocarbons, mostly by pipeline.¹¹⁵

This homogeneity reflects the similarities, if somewhat different risks, of a firm owning both types of transmission firms. Thus, it is reasonable to include a firm such as KMEP in the proxy group if the weight of the gas and oil pipelines is similar and the combined transmission function exceeds 50 percent.¹¹⁶ In fact, all parties did so in 2008, apparently overcoming any reservations regarding KMEP's oil pipeline component they had in 2004.

75. The Commission again concludes that the oil pipeline component of a diversified natural gas company will increase somewhat the firm's overall risk, primarily due to the oil pipeline industry's overall greater exposure to competition. However, this should not preclude the inclusion in a proxy group of a diversified firm having both components where, as here, the combined transmission function of 70 percent is significantly in excess of the 50 percent combined threshold previously discussed and no other one component predominates. Thus, the fact that KMEP has been included in oil pipeline proxy groups does not necessarily preclude its inclusion in a gas pipeline proxy group as the firm has a balanced investment in both businesses.

c. Enterprise

76. Enterprise is another MLP listed in Value Line's list of diversified natural gas companies. In 2004, Enterprise had minority interests in two small offshore NGA regulated pipelines (Nautilus and Venice Gathering System).¹¹⁷ In addition, in December 2003, it announced a five billion dollar merger with Gulf Terra Energy Partners, L.P. That merger was completed on September 30, 2004, thus giving Enterprise significant onshore intrastate pipeline facilities regulated in part under section 311 of the Natural Gas Policy Act of 1978.¹¹⁸ As of the end of 2004, after the merger with Gulf Terra, Enterprise's offshore pipeline facilities accounted for 9 percent of its assets and its

¹¹⁵ March 14, 2008 Issue; Staff Ex. 3 at 127.

¹¹⁶ See Opinion No. 486, 117 FERC ¶ 61,077 at P 154, n.248, finding that pipelines that primarily transport oil, petroleum products, or natural gas liquids should not be included in a natural gas pipeline proxy group. Opinion No. 486 also excluded firms that were predominately or exclusively electric firms. *Id.* P 129, 138.

¹¹⁷ Ex. BP-164 at 4.

¹¹⁸ Ex. BP-164 at 4; Ex. S-1 at 6-7.

onshore natural gas pipelines accounted for 49 percent of its assets. Enterprise also owned natural gas liquids pipelines regulated under the Interstate Commerce Act,¹¹⁹ which accounted for 36 percent of its assets.¹²⁰ Its other assets are related to petrochemical services.

77. Kern River proposes to include Enterprise in its 2004 proxy group. Trial Staff and BP argue that Enterprise should be excluded from any 2004 proxy group because it does not have an investment grade rating. Trial Staff asserts that the Commission now excludes firms from the proxy group that do not have similar credit ratings¹²¹ and that in 2004 Enterprise's rating was BB+, which is one notch below the lowest investment grade rating of BBB-, compared to Kern River's A3 rating.¹²² Trial Staff also asserts that El Paso and Williams, the companies the Commission previously excluded from the 2004 proxy group on the grounds of their poor financial condition, also had speculative investment credit ratings in 2004. Trial Staff also states that Enterprise's S&P business profile rating of 6 is riskier than Kern River's rating of 3. Kern River argues that Enterprise was almost of investment grade in 2004 and should therefore be included in the proxy group.

78. The Commission concludes that Enterprise should not be included in the proxy group for several reasons. First, until the Gulf Terra merger was completed near the end of the test period for this rate case, Enterprise was primarily a natural gas liquids pipeline regulated under the ICA, not a gas transmission firm. Enterprise's SEC Form 10-K indicates that during 2004 only 10 percent of its revenues were from the natural gas business, while 73 percent were from its natural gas liquids pipelines.¹²³ Similarly, natural gas transmission accounted for 19 percent of Enterprise's gross operating margin in that year, while natural gas liquids transportation accounted for 57 percent. Most of the 2004 data which would be used to calculate Enterprise's dividend yield if it were included in the proxy group is for the period before the Gulf Terra merger was completed. As BP states, during that period, Enterprise's natural gas transmission business was "insignificant."¹²⁴ BP also presents extensive and convincing evidence that

¹¹⁹ Interstate Commerce Act, 49 U.S.C. App. § 1, *et seq.* (1988) (ICA).

¹²⁰ Ex. S-3 at 8.

¹²¹ *Citing Southern California Edison Company*, 128 FERC ¶ 61,187, at P 27 (2008) (*SoCal*)

¹²² S-1 at 6-7.

¹²³ Ex. KR-133 at 1.

¹²⁴ Ex. BP-143 at 7.

Enterprise's natural gas liquids transmission business is particularly vulnerable to commodity risk due to the pricing mechanism it utilizes to transport natural gas liquids and related interest risk.¹²⁵ These points have merit because Enterprise's per barrel rate and margin is dependent on the margins of the underlying commodity transactions, and its tariffs are premised on the regulatory characteristics and risks of oil or petroleum pipeline, which were previously discussed in the context of KMEP.

79. Trial Staff and BP would also exclude Enterprise from the proxy group as a firm that has undertaken mergers or major acquisitions in the test year. Trial Staff asserts that such large scale activity can distort share prices by creating uncertainty (positive and negative) about the impact of change. Such transactions can also influence the stability of the dividend pattern.¹²⁶ In *Enbridge Pipelines (KPC)*, the Commission explained another reason for caution.

[T]he Commission observes that both of Dr. Olson's DCF analyses relied on a proxy group that included the Coastal Corporation (Coastal), El Paso Natural Gas Company (El Paso), Enron Corporation (Enron), Sonat Inc. (Sonat), and The Williams Companies (Williams). But KPC conceded at hearing that it was a mistake to have included Sonat in the proxy group because Sonat was merged with El Paso on March 15, 1999, during the test period and once a company is the subject of an acquisition, the growth rate is based on whatever is expected to happen between that time and when the buyout is completed, which is inconsistent with the Commission's method which seeks to compute a growth rate beyond five years.¹²⁷

80. Kern River argues Enterprise's lack of an investment grade rating was a short term function of a major acquisition with GulfTerra in 2004, a condition which continued until December 2006.¹²⁸ However, this simply establishes that Enterprise not only lacked an investment rating, the lack of that rating stemmed from adjustments to a major merger.

81. The Commission therefore concludes that Enterprise should not be included in the proxy group because its commercial characteristics are different from those of interstate gas pipelines and its financial profile was affected by a merger.

¹²⁵ *Id.* at 9-12 and 14.

¹²⁶ Ex. Staff S-1 at 6-7 (*citing Southern California Edison Company*, 122 FERC ¶ 61,187 at P 27 (2008) (*SoCal*)).

¹²⁷ *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at P 237 (2002) (*Enbridge*).

¹²⁸ Kern River Rebuttal Brief at 16-18.

4. The Diversified Natural Gas Corporations

82. In *Williston II*, *HIOS*, and Opinion No. 486, the Commission used the corporations in Value Line's list of diversified natural gas companies as the starting point for developing the proxy group. Such corporations not only have gas transmission operations, but also engage in other aspects of the natural gas business, including exploration and production, gathering and processing, marketing and trading, and distribution to retail customers. A central issue here is whether diversified natural gas companies whose pipeline operations constitute less than 50 percent of their business may nevertheless be included in a natural gas pipeline proxy group, given the court's decision in *Petal v. FERC* and the analyses in the Policy Statement. In the Policy Statement, the Commission did not preclude the use of diversified corporations in the proxy group. However, the Commission did recognize that the probable difference in the risk of the natural gas pipeline business and the risk profile of a diversified gas corporation with substantial local distribution activities was specifically recognized by the court in *Petal v. FERC*.¹²⁹

83. Trial Staff, BP, and RCG continue to include National Fuel, Questar and Equitable from the Value Line list of diversified natural gas companies in their 2004 proxy groups. BP also proposes to include NiSource and Southern Union. While neither of those corporations is on the Value Line diversified natural gas company list, in 2004 they were involved in both the natural gas transmission and distribution businesses, as well as other businesses. In support of their proxy group proposals, Trial Staff, BP, and RCG all assert that the diversified gas corporations they have selected have sufficient gas transmission assets to be included in the proxy group and that the distribution components of the diversified gas companies are only somewhat less risky than their interstate gas transmission assets. In reply, Kern River asserts that both *Petal v. FERC* and the Policy Statement held that local distribution company (LDC)-oriented natural gas corporations are not appropriate for inclusion in a gas pipeline proxy group, nor is this necessary for the year 2004. For the reasons discussed below, the Commission includes National Fuel in the proxy group, but excludes the other four corporations.

a. Whether to Preclude Inclusion in the Proxy Group

84. The Commission first concludes that neither *Petal v. FERC* nor the Policy Statement preclude the use of diversified natural gas companies in a gas pipeline proxy group as matter of law. In fact, in *HIOS* and *Petal v. FERC* the Commission and the court appear to have assumed that National Fuel, Questar, and Equitable were LDCs when evaluating whether these firms could be included in a gas pipeline proxy group. Thus, *Petal v. FERC* does not use the phrase "diversified natural gas corporations." The

¹²⁹ *Id.* at 6-7.

only references to National Fuel, Questar, and Equitable are as distribution companies, which is not how these firms are categorized by Value Line. Accordingly, *Petal v. FERC* appears to have concluded that National Fuel, Questar and Equitable were LDCs, or at least that the Commission's analysis assumed that they were the economic equivalent of LDCs.¹³⁰ This apparent factual assumption was incorrect. Moreover, the court stated that on remand it did not require any particular proxy group, but that the overall arrangement must make sense in terms of the relative risk and the statutory command to set just and reasonable rates commensurate with returns on investments in other enterprises having corresponding risks.¹³¹

85. The Policy Statement likewise states that “[w]hile the Commission is not precluding use of diversified corporations or MLPs in the proxy group, the probable difference in the risk of the natural gas pipeline business and the risk profile of a diversified gas corporation with substantial local distribution activities has been highlighted by the parties and specifically recognized by the court in *Petal*.”¹³² The Policy Statement did not hold that the difference in risk between the two types of firms is a given. Rather, the issue turns on the whether the components of a diversified natural gas corporation are such that its risk is comparable to a natural gas pipeline. This determination turns on the nature of the firm's components and its business environment.

86. There is little disagreement that the gathering and processing, exploration and production, and trading and marketing activities of a diversified natural gas company are riskier than the gas transmission, oil transmission, or gas distribution components. For example, a report by Moody's Investors Service on how it assigns ratings to North American diversified natural gas transmission and distribution companies describes both the gas pipeline and LDC businesses as relatively low risk because, among other things, “LDCs and pipelines earn regulated rates that lend predictability to their cash flows” and “employ relatively low-tech, long-lived assets and are characterized by low rates of technical innovation.”¹³³ The report then states, “Because these businesses are generally mature and offer limited growth, companies often diversify into other businesses that promise higher return, albeit at higher risk. Generally diversification is into a business

¹³⁰ *Petal v. FERC*, 496 F.3d 695 at 699.

¹³¹ *Id.* at 700.

¹³² Policy Statement, 123 FERC ¶ 61,048 at P 51 (*citing Petal v. FERC* at 6-7 in n.64) (emphasis added).

¹³³ *E.g.*, Staff Ex. S-3 at 76, *reproducing* Moody's Investors Service Rating Methodology, *North American Diversified Natural Gas Transmission and Distribution Companies*, March 2007 (Moody's *North American Diversified*).

within the gas value chain and related to the company's core regulated business. For example, [exploration and production] and [gathering and processing] are the most common areas of diversification."¹³⁴ The greater risk of these unregulated activities stems from a relative ease of entry into these markets, the greater exposure to price competition among firms already in the market, and the price volatility of the commodities involved. Within these more market oriented, as opposed to regulated, activities, gathering and processing is the least risky, exploration and production is more risky, and trading and marketing has the highest risk.¹³⁵ The presence of these other components leads Trial Staff and BP to argue that if a diversified natural gas company has a significant exploration and production function, the presence of these additional components can offset the lower risk of the LDC component.

87. BP further argues that higher natural gas prices have increased the risk of customer payment defaults and there is now increased regulatory risk because state public utility commissions are reluctant to pass on the higher prices.¹³⁶ BP also asserts that LDCs have always faced significant seasonal demand risk and that this risk has been enhanced by the increasingly volatile natural gas prices. It further asserts that LDCs are facing long term declines in gas demand as customers lower their overall demand and increased resulting revenue volatility.¹³⁷ BP further asserts that LDCs regularly face competition from other LDCs and now have greater risk than interstate gas pipelines may bypass the LDC to directly serve large end-user loads.¹³⁸

88. In contrast, Kern River argues that the testimony of its expert witness Dr. Olson reviews both the theory of such companies and specific characteristics of each of the diversified natural gas firms Staff and BP suggest.¹³⁹ It argues that these firms have integrated production and market storage functions that serve to reduce supply-side and market risk for the enterprise as a whole or that their pipeline revenues are highly dependent on, and supported by storage and transportation contracts of the regulated pipeline component and its distribution affiliates. Kern River further asserts that the integrated, diversified, business profile of such a firm is not comparable to Kern River's

¹³⁴ *Id.*

¹³⁵ *Id.* at 81.

¹³⁶ Ex. No. BP-94 at 65-66; Ex. No. BP-159 at 10, 11-14, 14-16, and 18-20.

¹³⁷ Ex. No. BP-94 at 67-68; Ex. No. BP-159 at 6-10, 16-18.

¹³⁸ Ex. No. BP-94 at 69-70; Ex. No. BP-159 at 5-6.

¹³⁹ Kern River Reply Brief at 15.

midstream transmission-only operations.¹⁴⁰ It further argues that most of the risks cited by BP in particular are offset by regulatory devices designed to stabilize the diversified gas company's local gas distribution operations.

89. The Commission concludes that a diversified natural gas company may not necessarily have "the highly different risk profiles" attributed to such firms by *Petal v. FERC*, or by the Commission in *HIOS* and Opinion No. 486. Staff and BP provide sound arguments why the LDC component of some natural gas distribution companies might have at least as much business and regulatory risk as an interstate natural gas pipeline. Given the record here, the Commission accepts Staff's and BP's general arguments that while LDC operations are less risky than interstate gas pipeline operations, this is not always true to the extent held by *Petal v. FERC* or Opinion No. 486. Thus, a diversified natural gas corporation with a LDC component need not be precluded from inclusion in a proxy group simply because the firm has such distribution operations, particularly if any lower risk of the distribution operations is offset by other higher risk activities.

90. The Commission also concludes BP and Trial Staff overstate the risk generally applicable to the LDC components of diversified natural gas companies. While it is true that the increased reliance on market-based supplies of gas and more volatile retail pricing may have increased the risk of traditional LDCs, this does not change the basic economic structure of the industry. Most LDCs remain local monopolies and often control alternative supplies of gas that help mitigate their gas price risk. Entry remains difficult and the risk of fluctuating gas prices is balanced by the use weighted average gas forms of pricing combined with pass through mechanisms which both shift the risk of changes to the consumer while evening out the worst fluctuations. Similarly, natural gas demand by some customers may have declined due to conservation, but gas is the heating and industrial fuel of choice because of its overall lower BTU cost. Most of these factors advanced by BP are reflected in the Moody's recent evaluation of the relative risk of LDCs and natural gas pipelines. In that evaluation, Moody's continues to consider LDCs to have a lower risk than natural gas pipelines even as it acknowledges that LDCs now face higher risks than when gas prices and entry were more strictly regulated.¹⁴¹

91. As Trial Staff and BP also argue, to the extent a diversified natural gas company's distribution business has lower risk than its pipeline business, that lower risk may be offset by the higher risk of the company's exploration and production and other unregulated natural gas activities. On the other hand, given the potential for price volatility in the gas commodity markets and the related higher risk, the more heavily a

¹⁴⁰ *Id.* 15-17.

¹⁴¹ Moody's *North American Diversified*, Ex. S-3 at 76-77.

firm is involved in any of the three more risky business groups previously discussed, the harder it may be to evaluate the diversified gas corporation's risk compared to a natural gas pipeline.¹⁴² The potential complexity of such an analysis is why the Commission adopted its historical standard of 50 percent of pipeline income, revenue, or assets for inclusion in a gas pipeline proxy group. This preferred threshold standard reduces the variance of the offsetting factors that may have to be evaluated. For the same reason, if a diversified gas corporation with substantial gathering and processing, exploration and production, and trading and marketing functions is to be included in the proxy group, no one of these components should exceed either of the less risky gas transmission or distribution functions to prevent overweighting the riskier components.¹⁴³

92. Thus, the Commission concludes if the firm has a total of more than 50 percent of gathering and processing, exploration and production, and trading and marketing components, the firm should be excluded from the proxy group. Therefore, it is equally true that if either of a diversified gas corporation's distribution or riskier non-transmission functions substantially outweigh its transmission functions,¹⁴⁴ the Commission would have "to make increasingly difficult determinations of relative risk" by assigning an appropriate weight to less risky distribution and the riskier, more market-oriented components.¹⁴⁵ The framework developed here will reduce the problems of such determinations and therefore will be used to determine which diversified natural gas corporations may be included the proxy group.

93. We now turn to an analysis of each of the diversified natural gas companies proposed for inclusion in the proxy group based on this framework.

¹⁴² See. Opinion No. 486, 117 FERC ¶ 61,077 at P 141, discussing how the losses experienced by El Paso, and similarly Williams, were largely related to their respective energy trading and related risk management operations, rather than to their gas pipeline businesses. These businesses proved to be much more volatile and risky than those of the gas pipeline industry. That was further reason to exclude the firms from the proxy group.

¹⁴³ *E.g.*, Staff Initial Brief at 11-12, comparing National Fuel, Northern Borders Partners L.P. and Questar Corporation.

¹⁴⁴ Policy Statement, 123 FERC ¶ 61,048 at P 51.

¹⁴⁵ *Petal v. FERC*, 496 F.3d 695 at 699; *Williston II*, 104 FERC ¶ 61,036 at P 35 n.46.

b. National Fuel

94. In 2004 National Fuel's net income profile was approximately 28 percent distribution, 28 percent natural gas transportation, 32 percent exploration and production, 3 percent trading and marketing, and 8 percent other.¹⁴⁶ Based on these numbers the Commission concludes that National Fuel is not the LDC dominated firm it was characterized as in *Petal v. FERC*, or in *HIOS* or Opinion No. 486. Moreover, the transportation and distribution components exceed 50 percent, are quite well balanced and the 35 percent total of the exploration and production and marketing and trading functions is similar in proportion to the transportation and distribution components. Thus, of the diversified natural gas companies presented here, National Fuel most reasonably conforms to the model in which the less risky distribution function is offset by the riskier exploration and production and marketing and trading functions. While the Commission would prefer to have a sample that consists of firms having at least a 50 percent gas transmission component, National Fuel meets the standards that would support its inclusion in the proxy group if this is necessary to provide an adequate sample size and one that provides a sensible ROE in the 2004 test year.

95. However, as previously noted, Kern River argues that National Fuel is unrepresentative because it is a vertically integrated firm. Thus, it asserts, the transmission and exploration and production functions are less risky because the LDC component provides a stable market for the other three functions. Kern River makes this argument without further supporting analysis or citation to any supporting materials, such as National Fuel's 2004 annual report or related SEC Form 10-K filing. Both of these are available on the company's web site at investor.nationalfuel.com. Given the concern regarding the inclusion of diversified natural gas companies in a proxy group, the Commission downloaded and reviewed National Fuel's 2004 Annual Report and the appended 10-K filing and will include the document in the record through an electronic filing. The report discloses that in 2004 National Fuel's natural gas pipeline operations consisted of 3,013 miles of natural gas pipelines and 32 storage fields. These operations generated \$47.7 million in net income and 28.6 percent of National Fuel's total net income, slightly more than National Fuel's \$46.7 million net income from its utility operations and representing 28 percent of its total income.¹⁴⁷ The report also states that the pipeline revenues have had the most consistent earnings and that utility income declined by some \$10.1 million in 2004 compared to 2003.¹⁴⁸ Both components are

¹⁴⁶ Ex. S-2, Schedule No. 1.

¹⁴⁷ *National Fuel Gas Company, 2004 Annual Report and Form 10-K (National Fuel Annual Report)* at Corporate Profile, 2-3, 9-12, 25-26, 28.

¹⁴⁸ *Id.*

described as being subject to competition with a mild weather and gas price risk being ascribed to the utility component, but that these are accommodated in part by regulatory adjustments that mitigate these risks.¹⁴⁹

96. Contrary to Kern River's assertions, only 40.6 percent of the gas storage capacity was committed to affiliated firms, and 46.2 percent of the transmission capacity was committed to unaffiliated parties.¹⁵⁰ The gas exploration and production component had net income of \$54.3 million, and has proved to be volatile.¹⁵¹ Moreover, most of the exploration and production was in areas far removed from National Fuel's western New York State distribution business, including the southwest, Gulf of Mexico, and Canada. The report states that most gas and oil is sold to third parties in the area in which it is produced.¹⁵² Thus, contrary to Kern River's unsupported assertions, the greater risk of the gas exploration and production function is not offset by National Fuel's vertically integrated operations. For these reasons, the Commission concludes that National Fuel's natural gas transmission function is not outweighed by its distribution function and that the greater risk exploration and production function reasonably offsets a somewhat less risky distribution function in this case. National Fuel may be included in the proxy group because it is not a predominately LDC diversified natural gas company.

c. Questar and Equitable

97. In 2004, Questar had 20 percent gas transmission business and 27 percent distribution business, or almost one third more distribution than transmission assets. It also had 51 percent of the more risky exploration and production business. Thus, its distribution assets substantially exceeded its transmission assets and the riskier production and exploration business exceeded the combined transmission and distribution functions.¹⁵³ This same was true of Equitable, whose distribution business of 27 percent was almost three times its natural gas transmission business of 11 percent. Its gathering and processing business exceeded both the other functions at 47 percent.

98. Trial Staff and BP have argued that the riskier components of a natural gas distribution firm can offset the less risky distribution function. Thus both Trial Staff and BP include Questar in their 2004 proxy groups but only BP includes Equitable in its 2004

¹⁴⁹ *Id.* at 8.

¹⁵⁰ *Id.* at 5-6.

¹⁵¹ *Id.*, Corporate Profile, 2, 30-31.

¹⁵² *Id.* at 9-10.

¹⁵³ Staff Ex. S-2, Schedule No. 2.

proxy group. However, for both Questar and Equitable, the transmission component is relatively small compared to any of remaining components, including the distribution component, and the riskier functions predominate. The Commission concludes that including either firm in the proxy group would require holding that (1) the greater distribution component is not predominantly greater than the gas transmission function, (2) that the greater risk of the gathering and production function only offsets, but does not overwhelm, the distribution function, or (3) that the lesser risk of both the transmission and distribution function, as combined, is not outweighed by the riskier components of these firms. Any such findings would require the Commission to assign an appropriate weight to less risky and riskier components under circumstances where the latter far exceed the gas transmission function.¹⁵⁴ Thus, neither Questar nor Equitable meet the Commission's current standards for inclusion in the proxy group.

d. NiSource and Southern Union

99. Only BP seeks to include NiSource and Southern Union in the 2004 proxy group. The Commission finds that neither should be included in the proxy group. Value Line categorized NiSource as an electric utility in 2004, not a diversified natural gas company. BP contends that this should not matter, because NiSource's gas operations far outweigh its electric operations. It states that in 2004 NiSource owned four interstate natural gas pipelines, Columbia Gas Transmission Corporation, Columbia Gulf Transmission Corp., Crossroads Pipeline Co., and Granite State Gas Transmission, Inc., and that NiSource's gas transmission, storage, and distribution assets represented 55 percent of the company's total assets in 2004, compared to 18 percent for electric operations.¹⁵⁵ However, the exhibit cited by BP shows that NiSource's gas pipelines represented only 18 percent of its assets in 2004, while gas distribution accounted for 37 percent of its assets. Moreover, in 2004, NiSource obtained only about 33 percent of its net operating income from gas pipeline operations, with over 40 percent from gas distribution and 29 percent from electric operations.¹⁵⁶ It is thus clear that NiSource's gas pipeline operations account for only a small proportion of its assets, that its distribution business is substantially greater than its gas pipeline business, and that its electric operations are approximately equal to its gas pipeline business. BP's own testimony indicates that NiSource's electric business is the distribution of electric power to retail customers,¹⁵⁷ which results in a total of 69

¹⁵⁴ *Petal v. FERC*, 496 F.3d 695 at 699; *Williston II*, 104 FERC ¶ 61,036 at P 35 n.46.

¹⁵⁵ Ex. No. BP-164 at 5, *citing* Ex. BP-124, page 1.

¹⁵⁶ Ex. BP-124, page 3 (net income ratios total more than 100 percent due to negative entries in other segment categories).

¹⁵⁷ Ex. BP-136 at 31-32.

percent in the lower risk distribution activities. In these circumstances, we find that BP has failed to show that NiSource is sufficiently comparable to Kern River to be included in the proxy group.

100. Value Line has categorized Southern Union as a gas distribution company, rather than a diversified natural gas company. BP nevertheless contends that it should be included in the proxy group, because it acquired Panhandle Energy on June 11, 2003, thus giving it a 100 percent ownership interest in Panhandle Eastern Pipe Line Co., Trunkline Gas Company, and Sea Robin Pipeline Co.¹⁵⁸ BP has also provided evidence that, as of June 30, 2004, Southern Union's gas pipeline business represented 48 percent of its assets and its gas distribution business accounted for 49 percent of its assets.¹⁵⁹ However, Trial Staff opposes inclusion of Southern Union in the proxy group, because it failed to pay a cash dividend in 2004 and instead issued a stock dividend. Trial Staff asserts that the DCF model is a discounted cash flow model and thus stock dividends should be excluded.

101. In order to justify including a firm that paid a stock dividend in the proxy group, the record must establish that the stock dividend can be considered an equivalent of cash dividend, for example by showing that the investor could convert the stock to a cash value with minimal risk. This might be shown by a demonstration that the stock price remains stable immediately after the distribution period and there is little or no dilution of the equity interest. However, no evidence was presented whether Southern Union's stock dividend was the reasonable equivalent of a cash dividend, and thus the Commission also excludes Southern Union from the proxy group.¹⁶⁰

5. Size of the Proxy Group

102. Based on the previous analysis the Commission has included five firms in the Kern River proxy group: two corporations, KMI and National Fuel, and three MLPs, Northern Border, TC Pipelines, and KMEP. The parties proposed different sized proxy groups for the 2004 test year. In its request for rehearing of Opinion No. 486-A, BP argued that no MLPs need be included in the proxy group to achieve a sufficiently large proxy group, but in the paper hearing BP proposes a nine member group for the year

¹⁵⁸ Ex. BP-164 at 4; Ex. BP-168 at 2.

¹⁵⁹ Ex. BP-124 at 5.

¹⁶⁰ See Staff Ex. S-4. The other parties do not provide evidence that would establish that the stock dividend was the equivalent of a cash dividend due to a lack of dilution and a stable stock price.

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2004 in its comments on the paper hearing.¹⁶¹ BP's proposed proxy group included six corporations, Equitable, National Fuel, NiSource, KMI, Southern Union, and Questar, and three MLPs, KMEP, Northern Border, and TC Pipelines. For the year 2004, Trial Staff proposed one proxy group of four members and two of five members.¹⁶² RCG proposed a seven member proxy group.¹⁶³ Kern River proposed a four firm sample for the 2004 test year.¹⁶⁴ Reliant proposed a three member group for the year 2004.¹⁶⁵ Kern River and Reliant both argue that their relatively small samples should be acceptable for the year 2004. Trial Staff, BP, Calpine, and RCG disagree, asserting that a three or four member proxy group is too small to be reliable or to be consistent with Commission policy.

103. BP argues at length that the larger the sample the more likely that the resulting ROEs will be statistically reliable. The statistical basis for the conclusion that a large proxy group is preferable is discussed by BP's witness Elizabeth Crowe. The greater the number of risk-comparable entities in the proxy group, the higher the probability that the results will be representative of the expected return in the gas pipeline industry. The smaller the number of entities, the higher the probability that some anomalous, unusual, or unrepresentative input will skew the results produced by the mathematical formula. Second, the more entities present in the group, the more likely it is that the addition or subtraction of an entity will not significantly alter the results of the calculation. The testimony contains an example of how the results from Staff's five member 2004 group would change if either of the two members below the median were removed, i.e., the median result would change by 60 basis points. Third, the larger the size of the proxy group, if the entities chosen are equally representative of Kern River's risk and operations, the greater the proportion of total NGA-regulated pipelines will be represented in the sample.¹⁶⁶

104. The Commission concludes that a proxy group should consist of at least four, and preferably at least five members, if representative members can be found. First, in

¹⁶¹ BP Initial Brief at 3-4.

¹⁶² Staff Initial Brief at 9-10.

¹⁶³ RCG Reply Brief at 5.

¹⁶⁴ Kern River Initial Brief at 6-10.

¹⁶⁵ Reliant Initial Brief at 6-7.

¹⁶⁶ Supplemental Phase Prepared Reply Testimony of Elizabeth H. Crowe, Ex. No. BP-143 pp. 10-13, *citing* Ex. No. BP-153.

Williston II, the Commission expressly found that three members were too small.¹⁶⁷ In *HIOS*, the Commission reluctantly relaxed the proxy group members in an effort to obtain four members even though a four member gas pipeline proxy group had previously been rejected by the Commission in *Enbridge Pipelines (KPC)*, where the Commission stated:

The removal of Sonat from the proxy group has the effect of reducing the number of comparable natural gas pipelines to four. In Transcontinental Gas Pipe Line Corporation, we rejected a proxy group containing only four companies because it was determined that four companies are too small a sample and may not be representative of industry conditions. Staff's analysis included five proxy companies. Thus, this is another reason staff's analysis is preferable.¹⁶⁸ (Interior citations omitted).

Utilizing a proxy group of at least five members serves this goal and, as did the Commission's historical practice, will help address BP's statistical concerns. At the same time, the proxy group members must be representative and have reasonably comparable risks under *Petal v. FERC*. Thus, while the Commission agrees that adding more members to the proxy group results in greater statistical accuracy, this is true only if the additional members are appropriately included in the proxy group as representative firms.

105. In the discussion above, the Commission has determined that only two corporations, KMI and National Fuel, are sufficiently representative to be included in the proxy group. The remaining corporations BP sought to include, Equitable, NiSource, Southern Union, and Questar, were not representative for the 2004 test year. Therefore, for the reasons previously discussed, they will not be included in the proxy group, and BP was incorrect in its rehearing request in asserting that a sufficiently large, risk appropriate proxy group could be developed without the inclusion of MLPs. The five firm proxy group, including three MLPs, selected here is sufficient to avoid BP's concerns raised in the paper hearing about a distorted sample.

¹⁶⁷ *Williston II*, 104 FERC ¶ 61,036 at P 35.

¹⁶⁸ *Enbridge*, 100 FERC ¶ 61,260 at P 237 (citing at n.236, *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414-A, 84 FERC ¶ 61,084, at 61,427-5 (1998)); *Iroquois Gas Transmission System*, 84 FERC ¶ 61,086, at 61,456 (1998); *Williams Natural Gas Company*, 84 FERC ¶ 61,080, at 61,358 (1998).

B. DCF Analysis of the Selected Proxy Companies

106. This order now turns to the issue of the appropriate DCF analysis of the five firms we have selected for the proxy group. Under the DCF formula used by the Commission, a firm's ROE is the sum of (1) the firm's dividend yield and (2) the projected growth rate. The Commission determines dividend yield by dividing the proxy firm's cash distribution (or dividend) by its current stock price. The Commission uses a two-step procedure for determining the constant growth of dividends: averaging short-term and long-term growth estimates. The Commission uses security analysts' five-year forecasts for each company in the proxy group (discussed below), as published by IBES, to determine growth for the short term; long-term growth is based on forecasts of long-term growth of the economy as a whole, as reflected in the GDP.¹⁶⁹ The short-term forecast receives a two-thirds weighting and the long-term forecast receives a one-third weighting in calculating the growth rate in the DCF model.¹⁷⁰

107. No party contests the application of this methodology to the two corporations we have included in the proxy group. However, both BP and Kern River raise issues concerning how this methodology should be applied to the three MLPs included in the proxy group. BP asserts that several adjustments must be made to the MLP's cash distribution for purposes of calculating their dividend yield. BP also contends that, absent an adjustment to the MLP's cash distribution, the Commission should not rely on IBES growth projections for an MLP's short-term growth projection. In addition, both BP and Kern River question the Policy Statement's conclusion that an MLP's long term growth projection should be 50 percent of projected long term GDP growth. Kern River also questions the use of the Social Security Administration's GDP growth forecast as one of the three GDP growth projections used for determining the long-term growth projection to be used in the DCF analysis for both corporations and MLPs.

1. Dividend Yield

108. In its request for rehearing of Opinion No. 486-A, BP argues that the Commission erred in finding that an MLP's dividend yield should be calculated based upon the full amount of its distribution. BP asserts two grounds for adjusting the cash distributions used in determining an MLP's dividend yield for purposes of the DCF analysis. First, BP contends that the Commission erred in holding that the MLP's distributions should not be

¹⁶⁹ *Northwest Pipeline Company*, 79 FERC ¶ 61,309, at 62,383 (1997) (*Opinion No. 396-B*); *Williston Basin Interstate Pipeline Company*, 79 FERC ¶ 61,311, at 62,389 (1997) (*Williston I*), *aff'd*, *Williston v. FERC*, 165 F.3d 54 at 57.

¹⁷⁰ *Opinion No. 414-A1*, 84 FERC ¶ 61,084 at 61,423-24.

capped at the level of earnings. BP points out that MLPs generally make distributions to unit holders in excess of their reported earnings, and thus the distributions include a return *of* invested capital, as well as a return *on* invested capital. BP states that the Commission provides for the return of a pipeline's invested capital through a separate depreciation allowance included in its cost of service. BP therefore asserts that, as the Commission found in Opinion No. 486, if an MLP's distributions are included in its DCF analysis without being capped at earnings, the resulting ROE will be too high. BP also presented testimony in the paper hearing to the same effect.¹⁷¹

109. The Commission thoroughly reviewed this matter in the Policy Statement¹⁷² and Opinion No. 486-A,¹⁷³ and concluded that the analysis in Opinion No. 486, upon which BP relies in its instant rehearing request, was fundamentally flawed based on the mechanics of the DCF model. The premise of the DCF model is that a firm's stock price should equal the present value of its future cash flows, discounted at a market rate commensurate with the stock's risk. Under the DCF model, all cash flows, whatever their source, are reflected in the value of stock. On the one hand, large cash flows in excess of earnings add value to the stock by increasing the current dividend yield. On the other hand, such cash flows take value away from the stock by reducing future growth potential.¹⁷⁴

¹⁷¹ Ex. BP-143 at 19.

¹⁷² 123 FERC ¶ 61,259 at P 58-63 and Appendix B.

¹⁷³ 123 FERC ¶ 61,056 at P 178-180.

¹⁷⁴ Two shipper exhibits in the instant docket support the conclusion that it is all cash flows, not income, that drives the DFC model. *See* Ex. No. RCG-29, citing Morin, *Regulatory Finance: Utilities' Cost of Capital* (1994) at 106-07, and Ex. No. RGC-1 at 29, which quotes Smith Barney as stating in part that earnings are not the basis for the valuation of MLPs because "for most MLPs, distribution levels are more directly related to operating cash flow than to GAAP earnings." While RCG cites this passage for the proposition there should be an adjustment for how a DCF analysis is applied to MLPs, the Commission concludes that it suggests the opposite. The time value of the cash distributions becomes the principal method for valuing an MLP, since those may be accelerated beyond the dividend distributions that would be made by a corporation under Generally Accepted Accounting Principles (GAAP) earnings. This is due principally to distributions of operating cash flows, including the part generated by the depreciation component of a firm's cost structure. That component is a non-cash expense item which affects a firm's income statement but not the net cash flow that may be available for distribution. The tax advantages of MLPs permit this cash to be returned to MLP unit holders more rapidly than to a corporation's shareholders, and the resulting present value
(continued...)

110. If the Commission were to cap the distribution used to determine an MLP's dividend yield at below the market-determined level, but use the actual market price of the MLP's publicly traded units and a growth projection reflecting the actual level of distributions, the DCF analysis would fail to achieve its intended purpose of determining the return the equity market requires in order to justify an investment in the pipeline. That is because there would be a mismatch among the inputs the Commission used for the variables in the DCF formula. The DCF analysis presumes that the market value of an MLP's units is a function of the entire present and future cash flow provided by an investment in those units. Given this interlocking nature of the variables in the DCF formula, adding the artificially reduced dividend yield to a growth projection that properly reflects investors' expectations of the MLP's reduced growth prospects due to its high actual distributions would inevitably result in an ROE lower than that actually required by the market.¹⁷⁵

111. In addition, use of a proxy MLP's full distribution in determining ROE will not cause a double recovery of the depreciation component included in the pipeline's cost-of-service rates. In a rate case, the Commission determines the dollar amount of the ROE component of the cost-of-service of the pipeline filing the rate case by multiplying (1) the percentage return on equity required by the market by (2) the actual rate base of the pipeline in question. Having found that use of a proxy MLP's full distribution is necessary for the DCF analysis to accurately determine the percentage return on equity required by the equity markets, it necessarily follows that the same percentage should be used in determining the dollar amount of the ROE component of the pipeline's cost of service. Awarding the pipeline an ROE allowance based on that percentage of its own rate base will give the pipeline an opportunity to provide its investors with the return on their investment required by the market. Such an ROE allowance does not implicate the separate depreciation allowance the Commission also includes in a pipeline's cost of service to provide for return of investment. The Commission illustrated these points with a numerical example set forth in Appendix B to the Policy Statement.¹⁷⁶

is reflected in the price of the MLP ownership interest. *See also* Policy Statement, 123 FERC ¶ 61,048 at P 58-61.

¹⁷⁵ The earnings cap on the distribution would artificially reduce an MLP's dividend yield below that assumed by the investor in valuing the stock. Adding the artificially reduced dividend yield to a growth projection that reflects the MLP's reduced growth prospects due to its high actual distributions would inevitably result in an ROE lower than that actually required by the market.

¹⁷⁶ Policy Statement, 123 FERC ¶ 61,048, Appendix B.

112. In its rehearing request and its evidence provided at the paper hearing, BP simply reasserts the Commission's findings in Opinion No. 486 were incorrect. It does so without expressly contesting any of the Commission's reasoning in Opinion No. 486-A and the Policy Statement for concluding that Opinion No. 486 reached an incorrect result on this issue. BP does not contest the Commission's explanation why capping the distribution used to determine an MLP's dividend yield at below the market-determined level, while using the actual market price of the MLP's publicly traded units and a growth projection reflecting the actual level of distributions, would lead to distorted results because of a mismatch among the inputs used for the variables in the DCF formula. BP also does not point to any error in the Policy Statement's Appendix B numerical example showing why a DCF analysis using a proxy MLP's full distribution, including any return of equity, does not lead to the award of an excess ROE in a pipeline rate case or the double recovery of depreciation. Accordingly, the Commission denies BP's rehearing request on this issue. The Commission continues to find that the fact an MLP makes distributions in excess of earnings is more appropriately accounted for in the growth component of the DCF analysis by using a growth projection which accurately reflects investor's expectations of reduced growth prospects due to the high level of distributions.

113. Second, in the paper hearing, BP contended that the Commission should adjust the amount of the distribution to be included in the DCF calculation by the amount of the corporate marginal tax rate that would otherwise have been paid on the MLPs income in the absence of its pass through status.¹⁷⁷ BP asserts that this adjustment is necessary to reflect the differences in taxation of a corporation and partnership. BP asserts that a corporation pays taxes on income and then makes a dividend payment to the shareholder, which pays a separate tax. Thus, it argues, the price of the corporate share reflects the after-tax value of the dividend. BP argues that, in contrast, an MLP unit holder does not pay tax on the distributions and therefore the results of the DCF calculation should be adjusted accordingly.

114. The Commission concludes that this argument is fundamentally inconsistent with the court's holding in *ExxonMobil v. FERC*. As the court stated, "the Commission reasonably relied upon evidence that a full income tax allowance is necessary to ensure that corporations and partnerships of like risk will earn comparable after-tax returns."¹⁷⁸ Inclusion of the projected cash flow from the income tax allowance in the DCF model does just that. While it is true that investors invest on the basis of after-tax returns and price an instrument accordingly, they expect that the cash flow will be available to pay the taxes and thereby maintain a comparable after-tax return to that of a corporation.

¹⁷⁷ Supplemental Phase Prepared Rebuttal Testimony of Elizabeth H. Crowe dated August 1, 2008, Ex. No. BP-164 at 19 (*citing* Ex. No. BP-158 at 3).

¹⁷⁸ *ExxonMobil Oil Corporation v. FERC*, 487 F.3d 945 at 957 (emphasis added).

Therefore, the Commission's DCF model does not double count the income tax aspects of a MLP partnership instrument.

115. At bottom, BP's argument confuses the investor's application of a DCF model with the Commission's. As discussed in the Policy Statement, the investor prices the instrument based on the perceived risks and the required return. That price necessarily reflects the after-tax cash that will be derived from the dividend component of the model. The Commission does the opposite to derive the cost of capital by looking at the price, the yield, and anticipated growth, and then determining the required return. If the Commission excludes the income tax allowance from the cash available for distribution, the price of the partnership units would drop to reflect the loss of the cash flow necessary to pay the imputed tax cost of the distribution stream. An MLP would have to issue more units to raise the same capital as a corporation of similar risk and its equity cost of capital would be notably higher. This violates the principle that firms of similar risks should have the same equity cost of capital and that this is to be reflected in their allowed returns.

116. Moreover, while the pricing of a MLP instrument may reflect the tax deferral components of such instrument, as the Income Tax Policy Statement explains, this is a matter of timing.¹⁷⁹ The difference in timing of the tax payments may lead the unit holder to pay a higher price for the unit and reduce the equity cost of capital to the firm, although not necessarily the amount of the income tax allowance included in the MLP's rates and borne by the ratepayers.¹⁸⁰ However, in reviewing the profile of firms to be included in a proxy group, the Commission looks only at information on the relative prices and yields of the securities issued by the candidate firms. Thus, for purposes of the Commission's DCF model, tax factors are assumed to be reflected in the unit prices and resulting dividend yields of the MLP.¹⁸¹ Therefore, there is no requirement to adjust the results to reflect the tax difference between a Subchapter C corporation and a MLP.

¹⁷⁹ Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 37, n.35. *See also*, *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 29, 31, 52-53.

¹⁸⁰ The Commission has held that the benefits of the any tax deferrals are for the enterprise and should not be credited back to the ratepayers. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 29. It should be noted that if the MLP is accorded the income tax allowance, the marginal tax rate for the limited partners is generally restricted to 28 percent. This can reduce the weighted marginal tax rate used to develop the income tax allowance several percentage points below the standard corporate rate of 35 percent.

¹⁸¹ The price of an MLP interest should reflect the risk of whether the MLP complies with the Commission's income tax allowance policy.

117. Finally, BP asserts that the fact that an investor's capital in an MLP is returned more quickly than capital invested in a corporation means that MLPs are intrinsically less risky and therefore an adjustment should be made to the overall DCF results to reflect this fact. BP would do so by adjusting the amount of the distribution to be included in the DCF calculation. This argument misses the fundamental point that *Petal v. FERC* and the Commission's rate making methodology address the relative risk of enterprises, which need not be determined primarily by their ownership format. As is discussed below, these factors can include the risk associated with the debt to equity ratio of the firm's capital structure, its interest cost and exposure, the stability of its markets and the related stability of its revenue stream, its cost structure, and its operating and managerial efficiency. These factors might be the same for three different firms, one of which is a corporation, the second a MLP, and the third one owned by individuals in their own name or through a general partnership. Assuming similar fundamentals, the equity ownership format may influence the actual or implicit pricing of the equity interest somewhat.

118. Thus, the fact that an MLP owner may recover the equity component more quickly means the instrument has somewhat lower risk and in theory the owner will pay a premium for that factor, which reduces the equity cost of capital to the firm, and hence, to the ratepayer. Conversely, the cost of equity capital to a general partnership, and to the ratepayer, might be a bit higher because the owners are exposed to personal liability. However, within a range of enterprises of similar risk, this should be reflected in the yield of the ownership instrument and would be reflected in the returns generated by the DCF model. Those results are likely to vary somewhat, but this should not preclude developing a proxy group with a reasonable range of returns if the firms' business fundamentals and risk are comparable. Again, any mechanical adjustment by the Commission would most likely be arbitrary, and BP does not explain why a formulaic approach would not be. Therefore, there should be no adjustments to reflect the difference in the distributions of a MLP and corporate dividends.

2. Short-Term Growth Projection

119. In both Opinion No. 486-A and the Policy Statement,¹⁸² the Commission held that IBES growth projections are properly used as the short-term growth projection in the Commission's DCF analysis of MLPs. In its request for rehearing of Opinion No. 486-A and its paper hearing testimony, BP asserts that the fact that MLPs' distributions often exceed the firm's book income means that the short term IBES growth forecasts are overstated, and that in any event, it is unclear whether IBES forecasts rely on distribution or income growth as the basis for the projection.

¹⁸² Policy Statement, 123 FERC ¶ 61,048 at P 67, 73-77.

120. In Opinion No. 414-A,¹⁸³ the Commission explained that the growth rate to be used in the DCF model is the growth rate expected by the market. Thus, the Commission seeks to base its growth projections on “the best evidence of the growth rates actually expected by the investment community.”¹⁸⁴ Moreover, the Commission stated, the growth rate expected by the investment community is not, quoting a Transco witness, “necessarily a correct growth forecast; the market may be wrong. But the cost of common equity to a regulated enterprise depends upon what the market expects not upon precisely what is going to happen.”¹⁸⁵

121. Opinion No. 414-A held that the IBES five-year growth forecasts for each company in the proxy group are the best available evidence of the short-term growth rates expected by the investment community. It cited evidence that (1) those forecasts are provided to IBES by professional security analysts, (2) IBES reports the forecast for each firm as a service to investors, and (3) the IBES reports are well known in the investment community and used by investors. The Commission has also rejected the suggestion that the IBES analysts are biased and stated that “in fact the analysts have a significant incentive to make their analyses as accurate as possible to meet the needs of their clients since those investors will not utilize brokerage firms whose analysts repeatedly overstate the growth potential of companies.”¹⁸⁶

122. While the Commission recognizes that there may be some statistical limitations to the IBES projections, BP has presented no evidence to cause the Commission to modify its previous holding that IBES remains the best and most reliable source of growth information available, including for MLPs. IBES publishes security analysts’ five-year growth forecasts for MLPs in the same manner as for corporations. MLPs must publicly report their earnings and distribution levels. Therefore, the security analysts are aware of the degree to which each MLP is making distributions in excess of earnings. The security analysts presumably take that information, together with all other available information concerning the MLP, into account when making their projections. No party questions the Commission’s findings in past cases that investors rely on the IBES projections in making investment decisions because they are widely available and generally reflect the input of a number of financial analysts. Also, since IBES projections are company-specific, they should already adjust for any differences among the entities analyzed, including any reduced growth prospects investors expect due to the fact an MLP makes

¹⁸³ 85 FERC ¶ 61,323 at 62,268-69.

¹⁸⁴ *Id.* at 62,269.

¹⁸⁵ *Id.*

¹⁸⁶ *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279, at 61,932 (2000).

distributions in excess of earnings. In fact, the 2004 IBES projections for the three MLPs included in the proxy group average 5.33 percent, while the IBES growth projections for the two corporations average 7.5 percent. Thus, those MLP growth projections are about 217 basis points (2.17 percent) below those for the corporations.¹⁸⁷

123. Thus, using a straight IBES five-year projection without modification presents the best method of estimating an MLP's short-term growth rate. At bottom, the IBES forecasts are what are available for the five year growth time frame. The analysts make whatever assumptions they make regarding the source of funds, the impact of those sources on growth in the shorter time frame, the degree to which certain of those sources may be used for distributions, and whether the growth projections are based on projected income growth or distribution growth. BP asserts that the security analysts' five-year growth forecasts appear generally to be forecasts of growth in earnings, rather than distributions. It argues that the relevant cash flows for the DCF model are the MLP's distributions to the limited partners, and therefore the growth projections used in the DCF analysis should be growth in distributions, not earnings. BP suggests no practical way to go behind the IBES forecasts and adjusting the short term growth component without using an arbitrary adjustment unsupported by a record. Accordingly, regardless of whether financial analysts stated they are reporting projected earnings growth or projected distribution growth for MLPs, the Commission finds the five-year growth rates that IBES reports are acceptable since they closely approximate distribution growth for MLPs, which is the short-term input for the DCF model.

124. In the Policy Statement proceeding, Professor J. Peter Williamson, on behalf of AOPL, reviewed historical IBES five-year growth forecasts for five oil pipeline MLPs since the mid-1990s. IBES had published five to nine growth forecasts for each the MLPs, with a total of 39 forecasts. Williamson compared each of these 39 forecasts to the MLP's actual growth in earnings and distributions during the subsequent five-year period. He found that 29 of the 39 IBES five-year forecasts, or 74 percent, were closer to the actual average distribution growths over that time span than the actual earnings growths. In his study, Williamson also found that historical records fail to support any claims that the IBES forecasts are biased or tend to overstate future growth.¹⁸⁸ In fact, 22

¹⁸⁷ This result is consistent with the Policy Statement, which concluded that the IBES growth rates for MLPs were consistently less than that of corporations. For interstate gas transmission pipelines, the March 2008 average IBES growth rate for corporations was 10.75 percent and 6.86 for MLPs, a difference of 389 basis points or 3.89 percent. Policy Statement, 123 FERC ¶ 61,048 at P 75. The range here is narrower because El Paso and Williams were excluded and the calculation is more conservative than that in the Policy Statement.

¹⁸⁸ AOPL, Post-Technical Conference Comments in Docket No. PL07-2-000, Williamson Aff. at 2-6.

of the 39 forecasts were lower than the actual distribution growth, and 17 were higher. Thus, far from showing a pattern of overestimating actual growth in distributions, the IBES growth projections underestimated growth in distributions 56 percent of the time, a conservative result.

3. Long Term Growth Projection

125. Kern River and BP both argue that limiting the long term growth component to 50 percent of GDP was incorrect, Kern River asserting that the growth factor is too low and BP that it is too high. Again, it should be noted that this is not a matter of comparable risk as that term is generally used in determining whether firms are of similar or comparable risk, and therefore whether they are appropriately included in the proxy group. Rather, as the Policy Statement discusses, the issue is whether MLPs as a class are likely to have a lesser long term growth rate than corporations as a class.¹⁸⁹ Consistent with the same methodology it has previously used to determine the long term growth rate for corporations,¹⁹⁰ the Commission concluded, based on its review of a range of estimates developed by established financial firms, that this was the case.¹⁹¹

126. The record here only reinforces the conclusions of the Policy Statement.¹⁹² For example, Trial Staff notes here that Citigroup's long term growth estimates for the three MLPs included in Kern River are 1.0 percent (Enterprise), 0 percent (KMEP) and .5 percent (Oneok Partners), and refers to the figures provided in BP's Supplemental Testimony for the Merrill Lynch and Wachovia long-term growth projections.¹⁹³ BP's testimony asserts that Merrill Lynch assigns a terminal growth rate of 1 percent to all MLPs in its analysis and that Wachovia's average long term growth rate for the MLPs in the BP proxy groups is 2.63 percent in 2004. BP asserts this compares to the 2.68 percent long term rate derived for the year 2004 using the Commission's 50 percent of long term

¹⁸⁹ Policy Statement, 123 FERC ¶ 61,048 at P 85, 88-89.

¹⁹⁰ *Id.* P 88-89.

¹⁹¹ *Id.* P 89, 90, with references to Kinder Morgan Energy Partners (KMEP). The Value Line analysis of this firm discusses its history of rapid growth through 2003 with less consistent results thereafter and an ambiguous forecast for the period after June 2008. See Staff Ex-3 at 153 of 227.

¹⁹² *Id.*

¹⁹³ Prepared Reply Affidavit of Commission Staff Witness Douglas M. Green, Ex. S-4 at P 24 and 25.

GDP formula.¹⁹⁴ Trial Staff concludes that the Commission approach is conservative and BP argues that it is too low, arguing the long term rate should be no greater than 1.8 percent.¹⁹⁵

127. Given the record in the Policy Statement proceeding and the record here, Kern River's general assertions that MLPs have the same long-term growth prospects as Subchapter C corporations are unconvincing. Nothing Kern River presents here contradicts the conclusions of the Policy Statement that MLPs face greater interest rate risk, more restrictive investment opportunities, and a risk of less consistent access to capital than do corporations because the latter can rely more on internally generated funds.¹⁹⁶ The Commission further notes that MLPs tend to have their fastest growth in initial years because of the general partner's efforts to increase its incentive distributions. As discussed in the Policy Statement, this emphasis on incentive distributions is likely to increase the cost of equity capital, which suggests fewer investment opportunities and declining returns in the long term.¹⁹⁷ The Commission therefore again concludes that MLPs should have a lower long term, or terminal, growth rate than that of corporations in the same business.

128. However, the Commission also concludes that the particularly low growth rates accorded MLPs by Merrill Lynch and Citigroup are inconsistent with the fact that many

¹⁹⁴ Prepared Supplemental Direct Testimony of Elizabeth Crowe, Ex. No. BP-121 at p. 13 and Ex. No. BP-128.

¹⁹⁵ *Id.* The 1.8 percent figure is the average of the Wachovia and Merrill Lynch forecasts for the MLPs included in BP's proxy group. This is a self-selected and narrower sample than the Commission relied on in developing the Policy Statement.

¹⁹⁶ Policy Statement, 123 FERC ¶ 61,048 at P 92-93. *See also* Opinion No. 486, 117 FERC ¶ 61,077 at 151, n.245 (citing Wachovia Securities, Master Limited Partnerships: A Primer (Ex. BP-19 at 11)) for the proposition that:

Because MLPs pay out virtually all of their cash to unitholders, they must continuously access debt and equity markets to finance growth. If MLPs were unable to access these markets or could not access these markets on favorable terms, this could inhibit long term distribution growth.

The cited Wachovia Securities report issued on November 16, 2003, long before the Commission began to pursue its Policy Statement in July 2007. The greater uncertainty regarding the long term growth prospects of MLPs is a longstanding investor issue.

¹⁹⁷ Policy Statement, 123 FERC ¶ 61,048 at P 92.

MLPs generate substantial returns over time, albeit with long-term growth rates that appear to be declining for even the more aggressive firms.¹⁹⁸ In contrast, the Wachovia studies are more nuanced with a wider and more discriminating range of terminal growth rates than the other two analyses,¹⁹⁹ which nonetheless serve to emphasize that some reduction in the long-term growth rates for MLPs is appropriate. In fact, the Wachovia forecasts cited by BP for 2004 and 2007 both result in long-term rates of approximately 50 percent of long term GDP,²⁰⁰ a similar result to the Policy Statement. Moreover, for the firms Trial Staff and BP included in their 2004 and 2008 samples, the application of the Commission's DCF methodology results in overall growth rates for the MLPs that are 22 to 50 percent less than those for the corporations.²⁰¹ For these reasons the Commission will retain the 50 percent of long-term GDP formula in this case. This will assure that MLPs receive comparable returns for firms of similar risks with an adjustment to reflect the intrinsic difference in the long-term growth prospects of Subchapter C corporations and the gas pipeline MLPs at issue here.

129. Kern River also objects to the use of the *Social Security Administration's (SSA)* GDP estimates in calculating the long-term growth component of the Commission's DCF model. Kern River asserts that those estimates do not reflect the historic growth of the economy, differ from the *Global Insight* and *Energy Information Administration (EIA)* growth projections, are not relied on by investors unlike *EIA*, *DRI/McGraw Hill (DRI)*, *Wharton Economic Forecasting Associations (WEFA)*, and *Global Insight*, are biased

¹⁹⁸ *Id.* P 87, n.118.

¹⁹⁹ For example, Merrill Lynch's terminal rate is a flat 1 percent without regard to the characteristics of the individual firm. The spread for the cited Citigroup firms is from zero to one percent. This is not consistent with the slow but steady growth in sales and distributions demonstrated by Oneok Partners between 2001 and 2004, a period of relatively low economic growth. *See* Ex. S-3 at 185. A similar conclusion could be drawn for TC Pipeline, L.P. (*Id.* at 54 of 227) and Buckeye Partners (*Id.* at 133 of 227).

²⁰⁰ As discussed above, the Commission is using the 2004 test year to develop the ROE in this proceeding. However, for the sole purpose of testing the Commission's long term methodology under the Policy Statement, it will use the various samples in the record for the period 1994 through mid-2008. This is appropriate given the challenges to the basic methodology of the Policy Statement in the current case by both sides and the evolution of the energy transmission industry over the several years preceding it.

²⁰¹ The five year period ended 2004 involved several recession years or years of low growth while the growth rate for the five years ended 2007 was higher. This supports the Commission's conclusion in the Policy Statement that MLPs may be less effective in raising capital when economic activity is lower.

because they result in a better projection of solvency for the social security system, and that the record here does not distinguish between the inflation and real GDP growth factors in the *SSA* model.

130. After review of Trial Staff's testimony,²⁰² the Commission affirms the use of three sources, *SSA*, *EIA*, and *Global Insight*, for the long-term growth estimate used in its DCF model. Before 2003, the Commission used GDP estimates by *DRI*, *EIA*, and *WEFA* to calculate the long-term growth projection. However, after the merger of *DRI* and *WEFA* and their acquisition by *Global Insight*, this left only two sources, including *EIA*. Thereafter the Commission accepted the addition of *SSA*'s GDP estimates thereby restoring three sources²⁰³ and then confirmed the inclusion of that estimate in the Policy Statement.²⁰⁴ The Commission further concludes that Kern River's argument about the past correlation of the *SSA*, *Global Insight*, and *EIA* forecasts is irrelevant because there is no necessary correlation between past forecasts and future forecasts. Trial Staff asserts that the variance between the forecasts had narrowed significantly by 2008, to only about 16 basis points. Moreover, to the extent the *EIA* and *Global Insight* forecasts are similar, this reflects in part the fact that they have overlapping components.²⁰⁵ There is no evidence here of the extent that investors rely on forecasts other than *SSA*'s GDP estimates or that the Commission has disclaimed reliance on any such finding.²⁰⁶ Regarding Kern River's inflation argument, the Commission's DCF model uses constant dollars and therefore this point is irrelevant.²⁰⁷ Finally, the Commission has previously affirmed the use of an average of the three long term forecasts in *HIOS*, a contested case, and that ruling was unchallenged.²⁰⁸

4. Determination of Proxy Group Range and Median

131. Based upon the above holdings, the Commission holds that the ROEs of the five firms selected for the proxy group are as follows: KMI: 13.00 percent; KMEP: 12.99

²⁰² See Ex. S-6 at P 11-18.

²⁰³ See *Williston Basin Interstate Pipeline Company*, 104 FERC ¶ 61,036 (2003).

²⁰⁴ Policy Statement, 123 FERC ¶ 61,048 at P 6, n.7.

²⁰⁵ Ex. S-6 at P 13.

²⁰⁶ See *Northwest Pipeline Company*, Opinion No. 396-B, 79 FERC ¶ 61,039 (1997).

²⁰⁷ Ex. S-6 at P 16.

²⁰⁸ *HIOS*, 110 FERC ¶ 61,043, at P 153 (2005).

percent; Northern Border: 11.55 percent; TC Pipelines: 10.35 percent; and National Fuel: 8.80 percent. Thus, the range of reasonable returns is 8.8 percent to 13 percent, and the median ROE is Northern Border's ROE of 11.55 percent.²⁰⁹ The Commission also finds that this distribution of ROEs among the five proxy group firms reinforces our previous conclusion that these firms constitute a risk-appropriate proxy group. All participants have agreed that Northern Border, whose pipeline facilities account for 91 percent of its assets, has a risk profile representative of the gas transmission business and is appropriately included in the proxy group. In addition, while the proxy group includes two firms with less than 50 percent gas transmission business, one (KMEP) has an ROE above the median, while the other (National Fuel) has an ROE below the median. Thus, their presence in the proxy group does not either increase or decrease the median established by Northern Border's ROE.

C. Kern River's Placement within the Range

132. The Commission's rate of return methodology requires an evaluation of Kern River's relative risk within the range of ROEs established by the proxy group. In this regard, the parties' comments raise two distinct issues. The first is the role of credit or business risk ratings in determining the relative risk of the firms included in the proxy group. The second is the actual determination of Kern River's relative risk.

1. The use of credit ratings

133. As part of its determination of whether a firm should be included in the proxy group, Trial Staff reviewed the Investment Credit Rating (ICR) and business risk profiles of several diversified gas corporations with a LDC component to determine if the overall credit and business risk of the firm was considered to be similar or different from firms that were primarily natural gas transmission firms. Trial Staff concluded that some such firms may have credit and business risk ratings indicating risk similar to or higher than a natural gas pipeline.²¹⁰

134. Kern River argues that credit ratings do not reflect business risk, and hence, a firm's equity risk. It argues that a credit rating says nothing about the risk a common stockholder faces concerning the expected cash flows in the form of MLP distributions or corporate dividends.²¹¹ As such, the constituency of the rating agency is the bondholder,

²⁰⁹ These ROEs are based on staff's DCF analyses for each proxy member, other than KMEP. The ROE for KMEP is based on BP's calculation.

²¹⁰ N. 135, *supra*.

²¹¹ Kern River Reply Brief at 18-19.

not the equity investor. Kern River further asserts that the Commission recognized that debt ratings by credit ratings are of only marginal relevance in assessing a pipeline's equity cost of capital, citing *Northwest Pipeline Corp.*:

The Commission also finds that the parties have ascribed an inordinate amount of significance to Northwest's ranking in the S&P reports. Contrary to the party's intimations, the Commission has never held that an ostensibly favorable ranking in the S&P reports is prima facie evidence of low business risk...²¹²

Kern River concludes that the Commission's prior statements mean that assertions that credit ratings can establish that diversified LDC enterprises have the same risk as a transmission pipeline are inconsistent with *Petal v. FERC* and the Policy Statement. It asserts that thus Trial Staff relies unduly on relative credit ratings to support its analysis.

135. BP also argues that credit ratings measure only credit risk stability and do not measure business risk. It argues that, as such, credit ratings do not adequately reflect such factors as growth and the importance of earnings stability to the equity owners. BP also asserts that an emphasis on credit ratings may overstate the relative risk of a firm like Kern River that has strong long-term growth potential and a favorable market position. BP also argues that Trial Staff used credit ratings to expand rather than to narrow the proxy group at issue here.²¹³ At bottom, it argues that Trial Staff's reliance on credit ratings may understate Kern River's relatively low risk when compared to a diversified natural gas company that has the same credit rating, but whose business risk is higher than Kern River's. BP thus shares some of the Kern River's criticism of Trial Staff's use of credit ratings, but appears to do so in order to reach an opposite conclusion from Kern River.

136. Trial Staff replies that it relied on two measures of relative financial strength and stability. One is the ICR, which ranks the relative credit risk of firms and is described in Appendix B to Mr. Douglas Green's Affidavit Dated June 17, 2008.²¹⁴ Trial Staff argues that the greater the risk to the bondholders the greater the risk the equity holders will not receive their payments and required return. Trial Staff also asserts that credit rating agencies such as Moody's do take such factors as revenue stability, growth potential, relative size and competitive position, diversification, and management in making credit

²¹² *Id.* (quoting *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,068 (1999)).

²¹³ See Ex. No. BP-136 at 9-53.

²¹⁴ Staff Ex. S-1, Appendix B.

evaluations, and as such do consider business risk. It states that it also considered business profile ratings to the extent these were available.²¹⁵ Finally, Trial Staff observes that Kern River's own witness routinely relied on credit ratings as an expert witness in state public utility commission rate proceedings.²¹⁶ RCG supports the Trial Staff position that credit ratings are relevant to risk evaluation because they reflect the financial soundness of the firm. RCG also argues that Kern River is incorrect that such ratings are irrelevant and that BP's attempt to minimize their value is misplaced.²¹⁷

137. Opinion No. 486 concluded that a pipeline's credit rating is an appropriate part of the risk analysis and is well established by Commission precedent.²¹⁸ The Commission again concludes that ICRs, as well as business risk profile ratings, are useful criteria in evaluating relative risk. Trial Staff has established that rating agencies such as Moody's use many factors that would be relevant to an equity investor's analysis of a firm's business prospects. It is correct that a strong credit rating implies a greater ability to provide consistent returns to the firm's stockholders and to raise capital for future growth. Moreover, Trial Staff supplemented its credit analysis with business profile ratings where the information was available. Such analyses are appropriate for determining relative risk within the range of ROEs established by the proxy group. For example, the two financial measures Staff suggests can prove useful for developing a more refined evaluation of the risk of diversified natural gas companies in the proxy group that have a number of different business lines. Thus, the Commission's use of such information would support the detailed analysis required by *Petal v. FERC*, not supplant it.

2. Determination of Kern River's Relative Risk

138. The remaining issue is the relative placement of Kern River within the proxy group. Opinion No. 486 started its analysis by reiterating the Commission's traditional assumption that gas pipelines generally fall into a broad range of average risk absent highly unusual circumstances that indicate an anomalous or low risk as compared to other pipelines. Thus, unless a party makes a very persuasive case in support of the need for an

²¹⁵ Staff Ex. S-3 at p. 94-95 and S-7, reprinting Standard and Poor's *Corporate Ratings Criteria, 2006*.

²¹⁶ Staff Rebuttal Brief at 6.

²¹⁷ Rebuttal Brief of the Rolled-In Customer Group and Answer in Opposition of Motion to Strike (RCG Rebuttal Brief) at 10-11 and Ex. No. RCG-41 at 4-5.

²¹⁸ Opinion No. 486, 117 FERC at P 177 (citing *Transcontinental Pipeline Corp.*, 90 FERC ¶ 61,279, at 61,937 (2000) (*Transcontinental*), Opinion No. 414-A, 84 FERC at 61,427, and *Williston*, 84 FERC at 61,388 (1998).)

adjustment and the level of the adjustment proposed the Commission will set the pipeline's return at the median of the range of reasonable returns.²¹⁹ However, Opinion No. 486 continued by recognizing that it had developed this policy at the time when the proxy group was made up entirely of companies that met the historical standards for inclusion in the proxy group, including that pipeline operations were a high proportion of the companies' business. The Commission further recognized that proxy groups had come to have fewer companies that met the historical standards.

139. The Commission therefore concluded where there is a small proxy group that contains companies with a relatively low proportion of pipeline business and substantial distribution operations, an adjustment would be necessary to reflect the difference between pipeline and proxy group members whose LDC operations account for a greater portion of their business than under the traditional standards.²²⁰ Given this framework, Opinion No. 486 held Kern River was a pipeline of average risk, but made an adjustment of 50 basis points to reflect the fact that Kern River faced competitive pressures and market risks that were higher than the LDC oriented firms within the proxy group.²²¹ This conclusion was contested on rehearing, with Kern River arguing that its ROE should be higher given its extraordinary risk,²²² and several shipper parties asserting that Kern River has significantly less risk than most interstate natural gas pipelines and the adjustment was inappropriate.²²³ Opinion No. 486-A did not address these arguments because such issues were set for a paper hearing.

140. On review, the Commission reiterates its existing policy, as announced in *Transcontinental Gas Pipe Line Corp.*, which assumes that pipelines fall into a broad range of average risk, absent highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines. Thus, unless a party makes a very persuasive case in support of the need for an adjustment and the level of the adjustment proposed, the Commission will set the pipeline's return at the median of the range of reasonable returns.²²⁴ The Policy Statement similarly stated that "the Commission has

²¹⁹ *Id.*

²²⁰ *Id.* at P 171.

²²¹ *Id.* at P 175.

²²² Request for Rehearing of Kern River at 47-51.

²²³ Request for Rehearing and Clarification of BP at 41-45; Request of the RCG for Rehearing and Clarification at 4-11.

²²⁴ *Transcontinental*, 90 FERC ¶ 61,279 at 61,936.

historically assumed the existing pipelines fall within a broad range of average risk” and that a “party has to show highly unusual circumstances that indicate anomalously high or low risk compared to other pipelines to overcome the presumption.”²²⁵ *Petal v. FERC* did not reject this historical assumption that most pipelines fall within a broad range of average risk and that, due to the difficulty of making refined adjustments, most are assumed to fall toward the middle of the range absent highly unusual circumstances. However, the court stated that this assumption was valid only if the firms included in the proxy group have comparable risks.²²⁶ Thus, given its concern whether LDC firms were comparable to natural gas pipelines, the court remanded that issue to the Commission.

141. In the prior sections of this order, the Commission analyzed in detail the various firms suggested for inclusion in the proxy group and selected three that consist primarily of gas transmission operations (KMI, Northern Border, and TC Pipelines); an MLP (KMEP) with significant gas and generally comparable oil transmission functions and no distribution or production and exploration functions; and one diversified natural gas company (National Fuel) that had a significant gas transmission function and whose less risky distribution function was offset by its more risky exploration and production functions. The Commission concluded several firms did not have the comparable business characteristics and risk that warranted inclusion in the proxy group, including: El Paso and Williams, whose returns and growth rates were unrepresentative in 2004; Enterprise, which lacked an investment grade rating and whose markets have considerably higher commodity risk; two diversified gas companies, Questar and Equitable, which had too wide a range of business interests and an insufficient percentage of transmission assets to be included in the proxy group; NiSource, whose business was dominated by lower risk gas and electric distribution activities; and Southern Union, which did not pay cash dividend during the relevant period. In doing so, the Commission developed a proxy group dominated by the pipeline transmission firms that the Commission has traditionally used and a fifth diversified natural gas firm that is not dominated by its LDC component. The Commission thereby addressed the court’s central concern of comparable risk by selecting a proxy group of firms with sufficiently similar business characteristics to assure a representative proxy group. Firms with characteristics that made them unrepresentative in 2004 were eliminated in the first instance. This makes it unnecessary to consider the adjustment that might be required if a

²²⁵ Policy Statement, 123 FERC ¶ 61,048 at P 7 (*citing id.*)

²²⁶ *Petal v. FERC*, 496 F.3d 695 at 700.

proxy group contains several companies with a relatively low proportion of pipeline business and substantial distribution operations, the concern addressed in Opinion No. 486²²⁷ and as recognized by the Policy Statement.²²⁸

142. The prior analysis also addresses BP's comment that it is not possible for all pipelines in a sample to fall within an average range since the word "average" necessarily implies that some members of the sample will have higher and lower risk that distinguishes them from the other member of the sample.²²⁹ This argument assumes that all possible firms fall within the proxy group and the broad average range that is appropriate for inclusion in the proxy group. However, this is not the case. As just discussed, the Commission eliminated those firms that might fall at the more extreme ends of the range of potential proxy group members. The firms that are left tend to have certain basic and similar transportation characteristics that cause them to fall toward the middle of the range of potential members. Thus, after assuring an adequate number of proxy firms by including MLPs in the sample, the Commission was able to define a more representative proxy group that reduces the risk that the proxy group might include firms having anomalously high or low risk compared to the natural gas pipeline industry as whole.

143. However, this broadening of the proxy group, however effective, does not eliminate the requirement to evaluate whether the historical presumption has been overcome with respect to Kern River's relative risk as compared to the firms within the proxy group. Turning to the merits, Kern River asserts that it serves fewer LDCs and more independent gas fired generating plants, and as such is faced with less stable demand and greater contract risk, as exemplified by the Mirant bankruptcy and that its actual exposure to contract defaults was growing during the test year 2004. It further asserts that its current natural gas transportation contracts have shorter terms than those of most natural gas pipelines, that a third of its contracts are with shippers that lack investment grade ratings, and that as a result the contracts of those shippers are of lesser value because they are supported by collateral of only 12 months of reservation charges. Kern River also argues that its Rocky Mountain supply basins are vulnerable to displacement by other pipelines and that those gas supplies may be in decline by the year 2015. It further asserts that its levelized rate methodology defers any recovery of its equity, thereby increasing its risk, and that any gains from accelerated depreciation are offset by the requirement to amortize the resulting regulatory obligation. Kern River claims that both these latter points are amplified by the fact its rate design assumes

²²⁷ Opinion No. 486, 117 FERC ¶ 61,077 at P 171.

²²⁸ Policy Statement, 123 FERC ¶ 61,048 at P 51.

²²⁹ BP Rebuttal Brief at 33.

operations at 100 percent of capacity. It further states that it is more highly leveraged than most interstate gas pipelines due to its 61 percent debt and 39 percent equity capital structure, and that its high percentage of undepreciated plant also exposes it to greater risk. In conclusion, Kern River asserts that due to its credit risk, financial risk and danger of defaults, its ROE should be set at a point mid-way between the median and the high end of the DCF range.²³⁰

144. In contrast, BP asserts that Kern River has consistently operated at more than 100 percent load factor usage for the last ten years, which indicates the strength of demand for its service when compared to other systems. It further claims that the fact that there is almost no discounting on the Kern River system, except for some very small contracts and certain specialized contracts with affiliate producers, highlights the fact that demand for Kern River's capacity is high. It further asserts that Kern River's contracts had longer terms in 2004 than at present and that its risk was accordingly lower than at the present time. BP further argues that supplies are increasing in Kern River's supply basins and that the pipeline's levelized rate design gives it a pricing advantage over new entrants. BP states that demand for gas fired generation is growing in California for environmental reasons and that this offsets any risk that might come from the higher cost fuel involved in gas fired generation. Furthermore, it states that the rapid recovery of Kern River's rate base over 10 and 15 years means that Kern River's Phase II rates will be lower than its competitors, which gives it a long-term advantage.²³¹

145. BP also argues that Kern River had no difficulty reselling the Mirant capacity, that it obtained a favorable settlement in present value terms, and that Opinion No. 486 provided an additional rate factor to cover the same risk. BP also asserts that, in contrast, Northern Border operates at a lower capacity factor than Kern River, that it has a less favorable contract profile, and that this is true if Kern River is compared to gas pipelines as a whole. BP argues that Kern River was acquired in 2002 by an investor known for making low risk investments in firms with stable earnings and good long term growth prospects and that this belies its arguments here. It asserts that Kern River's debt to equity structure has actually less debt than many other pipelines (with Kern River having a weighted average 52 percent debt to equity ratio across its multi-year contract profile). BP further argues that Kern River is building equity through its accelerated depreciation structure, which reduces its capital risk and which permits an accelerated capital recovery. For these reasons, BP concludes that Kern River's ROE should be placed the point mid-way of the median and the low end of the DCF range given that its risk is

²³⁰ Kern River Initial Brief at 14-19; Kern River Reply Brief at 28-36; Kern River Rebuttal Brief at 39-36.

²³¹ BP Initial Brief at 6-13; BP Rebuttal Brief at 23-35.

materially less than the other firms that should be included in the proxy group.²³² RCG and Reliant make similar arguments regarding Kern River's market position, reserves, load factor, its excellent credit rating, and the competitive advantage of its leveled rate structure.²³³

146. The Commission affirms its prior conclusion that Kern River falls within the broad range of average risk, but concludes here, in contrast to Opinion No. 486, that no adjustment to the return is required due to the change in the composition of the proxy group.²³⁴ This is because the Commission has excluded any clearly unrepresentative firms from the proxy group. In fact, the effort of the parties to push Kern River toward one end of the range or the other is emblematic of the difficulty of making refined determinations of risk within the proxy group. Thus, Kern River asserts that it has a higher risk of contract default based on its credit profile of its shippers and the fact that it serves fewer LDCs than many pipelines. But many of these shippers signed on for 10 and 15 year contracts that would permit accelerated recovery of Kern River's investment and amortization of its debt.²³⁵ Moreover Kern River has operated at consistently high load factors reflecting demand for its capacity and serves a market where demand for gas fired generation may actually compete for transportation capacity that would otherwise serve the LDC market.²³⁶ While Kern River experienced a number of smaller defaults in 2004, its loss reserves were actually less than its larger competitors in the California market in that year and these defaults do not appear to have affected its credit risk or business risk ratings.²³⁷ Moreover, its default risk is mitigated by Kern River's ability to market its existing capacity with only limited discounting, including the Mirant capacity, its one major default, on advantageous commercial and rate design terms.²³⁸ The decline of coal fired generation in the southwest clearly favors the gas fired generation Kern

²³² *Id.*; BP Reply Brief at 22.

²³³ RCG Initial Brief at 14-17; RCG Reply Brief at 6-7; Reliant Initial Brief at 13-16 and Reliant Reply Brief at 20-22.

²³⁴ Opinion No. 486, 117 FERC ¶ 61,077 at P 177-78.

²³⁵ *Id.* P 10, 16-18, 40, 48.

²³⁶ Ex. No. RES-16 at 25, Table 6; Ex. RCG-35 at 5; BP Rebuttal Brief at 24-25, 35, and Ex. No. BP-162.

²³⁷ Ex. No. RES-16 at 21-22; Ex. No. RES-1 at 22, Table 8; Ex. RCG-35, Schedule 5; RGC Initial Brief at 17.

²³⁸ BP Initial Brief at 7-8; BP Rebuttal Brief at 25; Ex. No. BP-94 at 8, 23-24, 35-36.

River serves and the continued demographic growth in the southwest should serve to mitigate Kern River's contract termination risk and that of entry by competing firms.²³⁹

147. Moreover, Kern River's assertion that it has an unrepresentative capital structure does not reflect the fact that this is a function of the levelized rate structure that was designed to mitigate financial risk and improve its competitive position. To this end, its capital structure is determined for each contract class based on the debt obligations of each set of levelized contracts, thus spreading that risk by specific shipper class.²⁴⁰ That debt is recovered on an accelerated basis given that its levelized rates were specifically designed to assure rapid recovery of its debt in no less than 15 years, a fraction of the regulatory useful life and rate base recovery of most interstate gas pipelines.²⁴¹ This accelerated depreciation schedule serves to mitigate its risk compared to older pipelines with a longer depreciation schedule but with greater accrued depreciation.

148. It is true that equity recovery may be somewhat deferred, but the present value of that deferral is built into the levelized rate structure and is therefore realized in part as the debt is retired.²⁴² As the reduced Phase II rates become effective Kern River's competitive position should be enhanced and its equity risk will decline significantly. This will further improve its competitive position regarding firms already in the market, other sources of supply, and new entrants.²⁴³ Thus, while BP and the other shippers understate Kern River's contract risk given its relative dependence on the more competitive generating market, Kern River exaggerates its financial risk given that its levelized rate methodology was specifically designed to mitigate its financial and competitive risks in the first instance.

149. Given the ambiguous nature of the record, the Commission will address with greater specificity the relative risk of the proxy group members, relying in part on the evidence of credit and business risk and the limited information provided on the individual firms. As previously discussed, the Commission held that such information is

²³⁹ BP Rebuttal Brief at 4 (*citing* Ex. No. BP-94), and 34-35 (*citing* Ex. Nos. BP-94, BP-136, and BP-139). *See Mojave Pipeline Company*, 81 FERC ¶ 61,150, at 61,888-90 (1997), in which the Commission also declined to establish a ROE above the median based on contract risk and competitive pressures in the California market.

²⁴⁰ Opinion No. 486, 117 FERC ¶ 61,077 at P 120, 176-177, n.291 and 292.

²⁴¹ *Id.* P 19-20, 43, 48.

²⁴² *Id.* P 40; Ex. No. RES-16 at 23;

²⁴³ Opinion No. 486, 117 FERC ¶ 61,077 at P 42, 49.

helpful in making more refined analyses inside the proxy group. The Commission first concludes that KMEP has somewhat more risk than Kern River because 35 percent of its income is from product pipelines and another 30 percent from CO2 pipelines and terminals where income has proven to be less stable.²⁴⁴ In terms of relative financial risk, in 2004 KMEP's Moody's rating was Baa1,²⁴⁵ and Kern River's was one notch higher at A3.²⁴⁶ Similarly, the S&P ratings were BBB+ for KMEP, and A- for Kern River.²⁴⁷ The comparative business risk ratings were 5 for KMEP, and 3 for Kern River.²⁴⁸ Both Moody's and S&P reflect a somewhat higher risk profile for KMEP.

150. The Commission also concludes that KMI has somewhat more risk than Kern River based on a review of their relative debt and business ratings. The Moody's bond rating for KMI is Baa2 and for Kern River is A3.²⁴⁹ The S&P bond ratings of KMI and Kern River are BBB and A-1 respectively and KMI's business risk rating is 5, compared to 3 for Kern River.²⁵⁰ The somewhat more risky ratings for KMI may be a reflection of its dependence on KMEP's earnings, and the underlying risk of some of KMI's own gas portfolio. This is despite the fact that KMI has a more diverse gas pipeline ownership portfolio for its own account and the presence of some retail utility operations.

151. The Commission further concludes that Northern Border is about the same risk as Kern River given the closeness of their relative financial risk. In 2004 Northern Border's Moody's rating was Baa2 compared to Kern River's A3. The comparative business risk ratings were 4 for Northern Border and 3 for Kern River. These ratings suggest that while Northern Border has a lower load factor and faces competitive and contract term pressures from the large number of interstate gas pipelines converging on the Chicago market,²⁵¹ these risks are comparable to the credit, competitive, and contract risk facing

²⁴⁴ Ex. S-2, Schedule No. 1;

²⁴⁵ Moody's rankings are A1, A2, A3, Baa1, Baa2, and Baa3 for investment grade obligations. *See* Ex. S-3 at 80.

²⁴⁶ Ex. RCG-40, Schedule 2.

²⁴⁷ The rankings for S&P are AAA, AA, A, and BBB for investment grade obligations. *See* Ex. S-7 at 3. A + or A - is a gradation within the same general ranking. The Fitch Ratings use the same ranking symbols as S&P. *See* Ex. S-5 at 1

²⁴⁸ Ex. S-2, Schedule Nos. 2 and 3.

²⁴⁹ Ex. RGC-40, Schedule 2.

²⁵⁰ Ex. S-2, Schedule Nos. 2 and 3

²⁵¹ BP Rebuttal Brief at 33; Ex. No. BP-136 at 19-23.

Kern River in the California market despite its higher load factor.²⁵² The Commission also concludes that TC Pipelines would be placed at a less risky point in the range as it has about the same risk as Kern River. While it has no debt, it had some financial risk in 2004 due to its minority status and its dependence on the dividends from its pipeline interests.²⁵³

152. The Commission further concludes that National Fuel has about the same risk as Kern River because National Fuel's pipeline operations have proven to be very stable and its utility operations, while somewhat vulnerable to seasonal fluctuations and prices, are offset by its regulatory environment. Its debt ratings are similar to Kern River's with Moody's giving both companies a rating of A3 in 2004 and S&P giving National Fuel a rating of BBB+ only slightly below Kern River's A rating. National Fuel has a higher business risk rating, perhaps reflecting the more volatile exploration and production business components of its business profile.²⁵⁴ However, these modest differences in debt ratings are not a basis to conclude that the two firms have materially different financial or business risk, particularly with National Fuel's history of solid, if somewhat fluctuating, earnings.²⁵⁵ The uncertainty from National Fuel's exploration functions is comparable to Kern River's risk due to the credit risk of some of its shippers or the variation in generator demand on its system.

153. Thus, while there are differences among the proxy group firms with three being somewhat more risky than Kern River, and two having about the same risk, all five proxy group members fall within broad range of average risk. There is no credible evidence in this record to support a finding that Kern River is of anomalously high or low risk compared the other members of the proxy group. To support such a finding a party must make a very persuasive case in support of the need for an adjustment to remove a firm from the broad average range.²⁵⁶ Nothing presented here meets that standard and except for the financial ratings, much of the evidence is ambiguous or countervailing. The Commission thus concludes that Kern River is of a similar risk to the overall risk of the

²⁵² Moreover, to the extent Northern Border's lower load factor is built into its rate structure and the current demand upon which those rates are premised is stable, this neutralized the difference in load factor difference between the firms. This observation demonstrates how simple numerical comparisons can be quite misleading.

²⁵³ *See e.g.*, Ex. S-1 at 19.

²⁵⁴ Ex. Staff S-2, Schedule No. 3; Ex. RGC-40, Schedule 2.

²⁵⁵ *National Fuel Annual Report* at 1.

²⁵⁶ *Transcontinental*, 90 FERC ¶ 61,279 at 61,936.

proxy group. Therefore there are no reasonable grounds here to adjust Kern River's ROE to a point above or below the median ROE of the proxy group selected here and the Commission holds that Kern River's ROE for the 2004 test year is 11.55 percent. Therefore the 12.50 percent ROE embedded in the September 30 Settlement is not just and reasonable and neither are the settlement rates in which it is embedded.

VI. Ruling on the Settlement

154. The 2008 Settlement is contested by BP and Southwest Gas and opposed by the Staff. Article 12 provides that the Settlement "shall not become effective and shall be void if the Commission chooses to approve it only as to the consenting parties rather than as to all parties,"²⁵⁷ thus precluding severance of any party to the proceeding. Trial Staff opposition stems from this provision on the grounds that it cannot reasonably be imposed on a contesting party.

155. In *Trailblazer Pipeline Co.*,²⁵⁸ discussing the Commission's standards for approving contested settlements, the Commission stated:

The Supreme Court has held that where a settlement is contested, the Commission must make "an independent finding supported by 'substantial evidence on the record as a whole' that the proposal will establish 'just and reasonable' rates." Consistent with this requirement, Rule 602(h)(1)(i) of the Commission's settlement rules provides that the Commission may decide the merits of contested settlement issues only if the record contains substantial evidence upon which to base a reasoned decision or the Commission determines that there is no genuine issue of material fact. If the Commission finds that the record lacks substantial evidence, or finds that contesting parties or issues cannot be severed, Rule 602(h)(1)(ii) provides for the Commission either (A) to establish procedures for the purpose of receiving additional evidence on the contested issues or (B) to "take other action which the Commission determines to be appropriate."²⁵⁹ (Interior citations in n. 263).

²⁵⁷ Reply Comments of Trial Staff on Offer or Settlement and Stipulation at 1, *citing*, Article 12, Sections 1 and 2 of the Proposed Settlement.

²⁵⁸ *Trailblazer Pipeline Co.*, 85 FERC ¶ 61,345 (1998), *order on reh'g*, 87 FERC ¶ 61,110 (1999).

²⁵⁹ *Id.*, 87 FERC ¶ 61,110 at 61,438 (*citing Mobil Oil Corp. v. FERC*, 417 U.S. 283, 314 (1974) (*Mobil*), *United Municipal Distributors Group v. FERC*, 732 F.2d 202, 207 n.8 (D.C. Cir. 1984), and 18 C.F.R. § 385.602(h)(1)(i), respectively).

The Commission also pointed out that the courts have reversed Commission orders approving contested settlements where the court found that the Commission did not give sufficient consideration to the interests of contesting parties, even if the settlement had wide support and there were only one or very few contesting parties.²⁶⁰

156. In light of this court precedent, *Trailblazer* explained four approaches for approving contested settlements that are consistent with the courts' requirements. As summarized in that case, these are: Approach No. 1, where the Commission renders a binding merits decision on each of the contested issues; Approach No. 2, where approval of the contested settlement is based on a finding that the overall settlement as a package provides a just and reasonable result; Approach No. 3, where the Commission determines whether the benefits of the settlement outbalance the nature of the objections, in light of the limited interest of the contesting party in the outcome of the case; and Approach No. 4, where the Commission approves the settlement as uncontested for the consenting parties, and severs the contesting parties to litigate the issues.²⁶¹

157. The parties concede that in this case the Commission may not use Approach No. 4 and sever the contesting parties under the explicit terms of the Settlement, nor can it use Approach No. 3 given that BP and Southwest Gas are both major shippers on the system. Thus, the Commission must utilize Approach No. 1 or Approach No. 2 if the Settlement is to be approved.

158. Under Approach No. 1, the Commission can approve a contested settlement, if there is an adequate record and the Commission can find that each of the contesting parties' contentions lack merit. BP comments raise four points that it considers to be genuine material issues of fact. These are: (1) mixed issues of law and material facts concerning the determination of Kern River's ROE; (2) whether Kern River is really experiencing negative Accumulated Deferred Income Tax balances; (3) related allocation issues; and (4) whether the billing determinants used in allocations of costs consistently reflect seasonal units of service for the 15-year rolled-in rates.²⁶² Southwest also objects to the 12.50 percent ROE embedded in the Settlement rates, as well asserting that the Settlement improperly limits the availability of the Periods Two and Three rates. Kern River and the supporting parties assert that a full factual record has been developed here,

²⁶⁰ In *Trailblazer*, 85 FERC ¶ 61,345 at 62,340-41, the Commission cited *Tejas Power Corp. v. FERC*, 908 F.2d 998 (D.C. Cir. 1990), *LaClede Gas Company v. FERC*, 997 F.2d 936 (D.C. Cir. 1993), *NorAm Gas Transmission v. FERC*, 148 F.3d 1158 (D.C. Cir. 1998), and *Southern California Edison Co. v. FERC*, 162 F.3d 116 (D.C. Cir. 1998)

²⁶¹ *Trailblazer*, 87 FERC ¶ 61,110 at 61,439.

²⁶² Initial Comments of BP dated October 28, 2008 at 9 (BP Initial Comments).

that the Settlement conforms to the Commission's merits findings in Opinion Nos. 486 and 486-A, and that the ROE embedded in the Settlement is within the range of reasonable equitable returns developed on the extensive record of this proceeding. In particular, Kern River asserts that the Commission should distinguish between legitimate disputes raised by the Settlement itself and new or untimely issues that are grounded in a party's objections to the levelized rate methodology that was litigated at hearing.²⁶³ RCG further argues that the material issues of fact raised by BP are embedded in a black box settlement whose components are within the bounds of the Commission's rulings in Opinion Nos. 486 and 486-A and therefore they need not be pursued further.²⁶⁴

159. The Commission concludes that it cannot impose the Settlement on the contesting parties under Approach No. 1, because it cannot find that each of the contesting parties' contentions lack merit. For purposes of the analysis here, the Commission accepts the supporting parties' representations that on all issues other than ROE, the Settlement is consistent with the Commission's merits determinations in Opinion Nos. 486 and 486-A. However, the contesting parties also assert that the 12.50 percent ROE embedded in the Settlement rates is too high. As fully discussed above, the Commission has held, based upon the paper hearing record, that Kern River should be awarded an ROE of only 11.55 percent, some 95 basis points lower than the Settlement ROE. Accordingly, the Commission cannot find that the contesting parties' contention that the Settlement is ROE is too high lacks merit.

160. Approach No. 2 provides for approval of the contested settlement based on a finding that the overall settlement as a package provides a just and reasonable result. Kern River asserts that this standard will be met if the rate resulting from the Settlement will be less than that which would be determined by the Commission on the merits.²⁶⁵ In particular, it asserts that the pre-tax return of 11.63 percent embedded in the settlement rates is well within the range of plausible litigation and is only 80 basis points higher than 10.82 percent pre-tax rate of return that would result from the rulings in Opinion No. 486.²⁶⁶ RCG argues more expansively that the benefits from approving the Settlement include: (1) the Settlement rates are less than the filed rates and in some cases close to or less than the pre-existing rates; (2) the Settlement provides for early implementation of

²⁶³ Reply Comments of Kern River in Support of Offer of Settlement and Stipulation at 5-6;

²⁶⁴ Reply Comments of RCG Requesting Prompt Approval of the Settlement at 7-9.

²⁶⁵ Kern River Reply Comments at 6.

²⁶⁶ Initial Comments of Kern River in Support of Offer of Settlement at 6-8.

the lower rates; (3) the Settlement avoids the need to rule on complex issues involving the compliance filing and ends four years of protracted litigation; (4) the Settlement provides for rate stability for four years; and (5) it provides for early resolution of issues related to the Period Two rates with full participation by the parties.

161. In contrast, Trial Staff asserts that the Settlement results in rates that are unreasonably high, that the Commission does not use the composite return cited by Kern River to establish rates, and the Settlement unduly constrains a shipper's right to challenge the settlement rates in the future.²⁶⁷ BP asserts that the Settlement may not be imposed on a contesting party for similar reasons.²⁶⁸ Southwest makes similar assertions and notes that the 80 basis points cited by Kern River add approximately \$14.5 million to its cost of service with a corresponding impact on its rates.²⁶⁹ Therefore, they conclude, the Settlement will not result in the just and reasonable rates required by *Mobile, supra*.

162. The Commission concludes that it cannot find that the overall settlement as a package provides a just and reasonable result, as required by Approach No. 2. Approach No. 2 does not require a merits finding on each of the issues raised by the contesting party. However, as the Commission explained in *Trailblazer*, under Approach No. 2 the Commission must find "that the contesting party would be in no worse position under the terms of the settlement than if the case were litigated."²⁷⁰ This entails an analysis of the Settlement's resolution of specific issues so as to determine whether a litigated result on some of the issues would have been more favorable to the pipeline than under the Settlement, thereby offsetting the fact that some of the contesting parties' objections may have merit. In such a situation, the Commission could find that "the result under the settlement is no worse for the contesting party than the likely result of continued litigation."²⁷¹ The Commission can make no such finding here.

163. As discussed above, the parties supporting the settlement state that it resolves all non-ROE issues consistent with the Commission's merits holdings in Opinion Nos. 486 and 486-A. Thus, the Commission cannot find that the Settlement resolves any issues in a manner that is more favorable to Kern River than a litigated result on those issues

²⁶⁷ Staff Rely Comments, *passim*.

²⁶⁸ BP Initial Comments at 12-13, 31-32, and 77-78.

²⁶⁹ Reply Comments of Southwest in Opposition to Offer of Settlement and Stipulation at 5-7.

²⁷⁰ 87 FERC ¶ 61,110 at 61,439.

²⁷¹ *Id.*

would have been. Rather, at best the Settlement resolves all issues consistent with the litigated result in this case, except for ROE as to which the Settlement reaches a result higher than the ROE the Commission has found to be just and reasonable. It follows that the Settlement rates are higher than the just and reasonable rates determined pursuant to the litigation in this proceeding.

164. Moreover, the Settlement does not appear to provide any other benefit sufficient to offset the fact the overall Settlement rates are higher than the just and reasonable rates determined in this proceeding. It does not appear that the Settlement will result in a significant reduction in litigation for several reasons. As the parties note, the record is virtually complete and the Commission has made merits findings at this point on all issues that are necessary to support a revised compliance filing and the underlying cost elements that would be used to develop that compliance filing. Those findings include the findings on ROE in this order and various rulings in Opinion Nos. 486, 486-A, and this order regarding the determination of Kern River's Period One rates. The Settlement itself provides for further litigation concerning Kern River's Period Two rates, and the Commission is also ruling here that further review of the Period Three rates would be administratively wasteful. Moreover, nothing in the Settlement precludes a judicial appeal by BP and Southwest on the merits of a Commission order approving the Settlement.

165. For the same reasons, the proposed settlement will not result in rate certainty and administrative efficiency, either retrospectively or prospectively. Even if the Commission were to approve the Settlement, that decision would likely be appealed and the rates and refunds the Settlement provides to all parties would be subject to the risk of reversal on appeal. These uncertainties could be reduced if the Settlement permitted the Commission to sever the contesting parties under Approach No. 4. However, the Settlement clearly removes that possibility from the Commission's hands.

166. Given these conclusions and the Commission's prior holding that the rate of return of 12.50 percent embedded in the Settlement rates cannot be found to be just and reasonable under either Approach No. 1 or Approach No. 2, the Commission need not reach the other objections raised by Trial Staff and the contesting parties BP and Southwest. Finally, the Commission notes that the result here is consistent with the recent decision in *Petal v. FERC*, where the court emphasized that "the Commission may adopt an uncontested settlement *only* "after finding it is fair and reasonable and in the public interest."²⁷² It necessarily follows that the Commission must make the same finding for a contested settlement, which it cannot do here given that there is no justification on the record for approving a ROE that is in excess of the median ROE adopted by this order. Therefore the Settlement is rejected.

²⁷² *Petal v. FERC*, 496 F.3d 695 at 700.

VII. BP's Rehearing Request Concerning Periods Two and Three Levelized Rates

167. In its June 16, 2008 request for rehearing of Opinion No. 486-A, BP requests clarification, or in the alternative, rehearing of several issues related to Kern River's levelized rate structure. BP's requested clarifications focus on the three rate periods set forth in Opinion No. 486,²⁷³ as reaffirmed by Opinion No. 486-A.²⁷⁴

168. In order to address these issues it is necessary to briefly review Kern River's initial rate proposal. Kern River proposed to continue its levelized rate methodology which was first approved in the certificate authorizing its Original System.²⁷⁵ That methodology includes separate rates for three different periods: (1) the 15-year term of the firm shippers' initial contracts (Period One), (2) the period from the proposed expiration of those contracts to the end of Kern River's depreciable life (Period Two), and (3) the period thereafter (Period Three). The levelized rates for Period One were designed to permit Kern River to recover approximately 70 percent of its original investment, an amount approximately equal to the portion of its invested capital funded through debt. Since this would allow Kern River to recover more invested capital during Period One than it would under ordinary straight-line depreciation for the depreciable life of the project, the rates for Period Two and Period Three were lower than the Period One rates.²⁷⁶ In Opinion Nos. 486 and 486-A, the Commission accepted the use of these rate periods by Kern River and, in order to increase the assurance that Kern River's shippers will obtain the benefit of the lower Period Two rates if such shippers continue service beyond the terms of their existing contracts, the Commission directed that Kern River

²⁷³ Opinion No. 486, 117 FERC ¶ 61,077.

²⁷⁴ Opinion No. 486-A, 123 FERC ¶ 61,056 (2008).

²⁷⁵ Kern River proposed to continue using the rate levelization methodology and cost of service rate principles as approved in the original Kern River certificate proceeding, *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069 (1990), its extended term (ET) rate settlement proceeding, *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061 (2000), *reh'g denied*, 94 FERC ¶ 61,115 (2001), its 2003 Expansion certificate proceeding, *Kern River Gas Transmission Co.*, 100 FERC ¶ 61,056 (2002), and prior Kern River rate case settlements, *Kern River Gas Transmission Co.*, 70 FERC ¶ 61,072 (1995); *Kern River Gas Transmission Co.*, 90 FERC ¶ 61,124, *order on reh'g*, 91 FERC ¶ 61,103 (2000).

²⁷⁶ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 2.

include in its tariff the Period Two rates that will take effect when the firm shippers' existing contracts expire.²⁷⁷

169. In its rehearing request, BP argues that the Commission should clarify that if Kern River retains debt during the effectiveness of the Period Two rates, the level of such rates must be adjusted to provide any resulting benefits to Shippers. Secondly, BP argues that the Commission should clarify that the excess depreciation recovered by Kern River from certain capacity during Period One will, during Period Two, be used only to derive rates for the same capacity. Third, BP argues that the Commission should clarify that Kern River's shippers will continue to get the benefit of their bargain in Period Three. Lastly, BP asserts that it requests rehearing regarding any issue for which its requested clarification is not granted. The Commission will address these issues in turn.

A. Period Two Debt Rate Adjustment

170. BP asserts that Opinion No. 486 states that "the Commission did not [in Kern River's initial certification proceeding] mandate the recovery of debt in any particular timeframe."²⁷⁸ BP also asserts that in implementing Kern River's ET program, the Commission stated that "after the debt attributable to the original system construction is repaid, [Kern River's] transportation rates will step-down to a lower level."²⁷⁹ BP states that on rehearing of Opinion No. 486 it expressed concern that these statements, taken together, might allow Kern River to argue that Period Two step-down rates could not be implemented until all its debt is repaid.

171. BP argues that in Opinion No. 486-A, the Commission clarified that "if Kern River refinances its debt, and the debt, therefore, is not extinguished before the implementation of the Period Two rates, the level of the Period Two rates may be adjusted to reflect any benefits to shippers from such action but not any detriment to shippers."²⁸⁰ It asserts that this clarification did not fully clarify the issue because the use of the word "may" creates additional uncertainty regarding whether the level of Kern River's Period Two rates must be adjusted to reflect the benefit to shippers if Kern River refinances its debt before the implementation of Period Two rates. Therefore, BP requests that the Commission clarify that if Kern River retains debt in its capital structure

²⁷⁷ *Id.* P 11.

²⁷⁸ BP Request at 28 (*citing* Opinion No. 486 at n. 90).

²⁷⁹ *Id.* (*citing* *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061, at 61,159 (2000)).

²⁸⁰ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 46.

during the time Period Two rates are being collected, the level of Period Two rates must be adjusted to reflect any benefits to shippers from such action but not any detriment to shippers.

172. In Opinion No. 486-A, the Commission, in discussing the composition of Kern River's Period Two Rates, determined that the Period Two rates must be filed with the effective dates linked to the expiration of the 10 or 15 year contracts currently held by Kern River's shippers, and that the Period Two rates must be based upon no more than 30 percent of Kern River's current rate base, which is an amount corresponding to the amount of equity under Kern River's capital structure. In addition to this finding, the Commission also stated that

[I]f Kern River refinances its debt, and the debt, therefore, is not extinguished before the implementation of the Period Two rates, the level of the Period Two rates may be adjusted to reflect any benefits to shippers from such action but not any detriment to shippers.²⁸¹

173. The Commission reasoned that in determining the Period Two rates refinancing would not change the level of the remaining rate base at the end of the levelization²⁸² and pointed out that, as Kern River had stated:

if Kern River refinances its debt and/or debt is not fully extinguished at the end of the respective shipper contracts, Kern River's Period Two rates cannot be higher than if it had used all the depreciation collected during Period One to pay off its debt. The entire depreciation allowance reflected in Kern River's Period One rates must be subtracted from rate base in calculating the Period Two rates regardless of Kern River's actual use of these funds. Thus, the rate base used to design Kern River's Period Two rates may not reflect

²⁸¹ *Id.*

²⁸² The Commission also cited to Kern River's Brief Opposing Exceptions which stated:

The only effect of a refinancing would be that the remaining rate base after levelization would be capitalized partly with debt and partly with equity, rather than entirely with equity. Moreover, because debt capital costs less than equity capital, Kern River's post levelization shippers *would be better off* under refinancing than if Kern River maintained the nearly 100 percent equity capital structure that would otherwise exist. Ex. Nos. KR-23 at 20, KR-29 (emphasis in original).

more than 30 percent of its original invested capital no matter what the level of its outstanding debts. However, as Kern River states, if some of that rate base is, contrary to current expectations, financed by debt rather than equity, that fact will be reflected in the calculation of the Period Two rates. Since debt is cheaper than equity, this would reduce the Period Two rates below what they would be otherwise. Thus, there is no way that the shippers could be harmed by Kern River's failure to pay off all of its debt during Period One.²⁸³

174. BP requests that the Commission clarify that if Kern River retains debt in its capital structure during the time the Period Two rates are being collected, the level of Period Two rates must be adjusted to reflect any benefits to shippers from such action but not any detriment to shippers. The Commission grants the requested clarification consistent with the above discussion, subject to one caveat. As required by the NGA, any change in the Period Two rates after they are approved in the compliance phase of this proceeding can only be implemented pursuant to a section 4 rate filing by Kern River or a section 5 action by the Commission.

B. Use of Depreciation in the Derivation of Period Two Rates

175. BP asserts that the Commission should clarify that excess depreciation recovered by Kern River from certain capacity during Period One will be used only to derive rates for the same capacity during Period Two.

176. BP states that Opinion No. 486-A does not explicitly provide that the excess depreciation recovered by Kern River during Period One will be flowed back, during Period Two, to the same capacity from which the excess recovery was obtained. Therefore, BP requests that the Commission clarify that the same capacity that over-funded depreciation will be charged a rate during Period Two that reflects the full benefit of that overfunded amount, presuming the same shipper(s) have retained the capacity in Period Two. BP also asserts that if the same shippers do not retain capacity in Period Two the Commission must specify how Kern River's over-recovery will be returned and explain how Kern River will be prevented from retaining the excess revenue.

177. BP argues that Opinion No. 486-A claims to protect the parties' bargained-for benefits but that a failure to accurately track the over-collection for purposes of deriving a Period Two rate for the shipper who has paid the excess depreciation would violate the parties' bargain. BP asserts that it would be inconsistent with cost based ratemaking by failing to credit to the over-contributing shipper the value of the over collection, or to

²⁸³ *Id.* (citing Kern River Brief Opposing Exceptions at 33).

allow Kern River to retain such over-collection. BP asserts that this would result in subsidization and violation of the Commission's 1999 Pricing Policy Statement,²⁸⁴ which requires that existing shippers not subsidize shippers using a subsequent and more costly expansion.

178. In Opinion No. 486, the Commission recognized that Kern River's levelization methodology would levelize Kern River's rates over several different periods, so that Kern River can recover 70 percent of its invested capital through the Period One levelized rates in effect during the terms of the shippers' current contracts. The Commission noted that, as a result, unlike the usual situation with levelized rates, Kern River's levelized rates will recover less of its costs during the early years of Period One than under traditional rates. However, the Commission continued to state that by the end of Period One those rates will have recovered more costs than traditional rates would have recovered at that stage of Kern River's life. The Commission stated that, "Kern River will then return this excess recovery to its shippers during Period Two, through the step-down rates to be implemented at the start of Period Two."²⁸⁵

179. The Commission, as it explained in Opinion No. 486,²⁸⁶ required that Kern River keep track of its recovered depreciation from ratepayers in a separate account. The Commission directed that Kern River record annual book depreciation as an addition to Account No. 108 (Accumulated Depreciation Expense), and a regulatory asset or liability is booked for the difference between the annual regulatory depreciation expense it recovers in rates and the book depreciation expense it records in Account No. 108. The Commission also stated that, "[a]t the end of Period One, the regulatory liability, which BP asserts will amount to \$500 million, will be reflected in the Period Two rates and thereby returned to Kern River's shippers."²⁸⁷

180. Lastly, in Opinion No. 486-A, the Commission found that Kern River's proposal to file Period One rates that would collect approximately 70 percent of its original costs from its shippers over either a ten or fifteen year period (depending on the length of their contracts) which would then be followed by Period Two rates that would be based upon the remaining 30 percent at the expiration of the original ten or fifteen year term was unjust and unreasonable because it did not provide adequate assurances that its shippers

²⁸⁴ *Certification of New Interstate Natural Gas Pipeline Facilities*, 88 FERC ¶ 61,227 (1999).

²⁸⁵ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 26.

²⁸⁶ Opinion No. 486, 117 FERC ¶ 61,077 at P 47-48.

²⁸⁷ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 28.

would obtain the benefit of the lower Period Two rates if they continued service beyond the terms of their existing contracts. Therefore, the Commission directed Kern River to file revised tariff sheets setting forth its currently proposed rates based upon the instant cost of service as well as the rates and effective date of the step-down Period Two rates to be available to its 10 and 15 year shippers.²⁸⁸

181. Therefore, the Commission has found that Kern River must record this excess recovery (as opposed to straight line depreciation) and return it to its shippers during Period Two, through the step-down rates filed in Kern River's tariff and based upon the instant cost of service. BP requests that the Commission also add that the excess depreciation recovered by Kern River during Period One will be flowed back, during Period Two, to the same capacity from which the excess recovery was obtained. BP also asserts that if the same shippers do not retain capacity in Period Two the Commission must specify how Kern River's over-recovery will be returned and explain how Kern River will be prevented from retaining the excess revenue.

182. The Commission declines to grant BP's requested clarification. The Commission has required that the excess depreciation amounts be recorded and that the Period Two rates be calculated to return any excess amounts to the shippers during Period Two. Kern River is required to place these Period Two rates in its tariff. BP is free, in the compliance phase of this proceeding, to object to Kern River's proposed Period Two rates if it believes that the rates set forth by Kern River do not correctly return any overfunded depreciation amounts from Period One. This would include any issue concerning whether Kern River has properly allocated the returned depreciation amounts among the relevant customer groups.

183. The Commission will not specify that shippers that do not retain capacity in Period Two will derive any benefit from Kern River's rate methodology. The bargain in this proceeding is based upon continued use of the facilities. If a shipper determines that it is in its best interests to terminate service at the end of its current contract and thereby forego the benefit of Period Two rates, the Commission will not require any special modification of the Period Two or Period Three rates to reflect this fact other than the usual change in rate design volumes that would occur in a pipeline's next rate proceeding.

C. Period Three Rates

184. BP argues that the Commission has only directed Kern River to include in its tariff the Period Two rates that will take effect when the firm shippers' existing contracts expire. However, BP asserts that the Commission has not provided a mechanism to

²⁸⁸ Opinion No. 486, 117 FERC ¶ 61,077 at P 61-62.

ensure that Period Three rates continue to provide Kern River's shippers with the benefit of the levelization bargain. BP requests that the Commission clarify that Kern River's Period Three rates will continue to be based on the principles articulated in the orders certificating Kern River and otherwise will continue to reflect the benefit of their bargain. Also, BP requests that Period Three rates be restated now consistent with the practice commenced in the original certificate order, and derived using the same principles used in the certificate orders governing the Original System.

185. BP argues that there is no assurance that Kern River will file another rate case before step down Period Two rates would take effect in 2011 for Original System 10 year shippers.²⁸⁹ Therefore, in order to retain capacity during Period Two, pursuant to ROFR procedures, BP may have to match bids at the maximum rate not just for Period Two, but also those in effect during Period Three for such capacity. BP argues that without stated maximum Period Three rates, the ROFR process will be needlessly contentious.

186. The Commission will grant the requested clarification in part. First, BP states that the Commission should clarify that Kern River's Period Three rates will continue to be based on the principles articulated in the orders certificating Kern River and otherwise will continue to reflect the benefit of their bargain. The Commission so clarifies its orders. Throughout this proceeding, the Commission has been consistent in finding that the parties will retain the benefit of their bargain and that the levelized methodology will be maintained in absence of an overarching policy reason.²⁹⁰ In Opinion No.486-A, the

²⁸⁹ The Commission stated in Opinion No. 486 that as a result of the contractual options presented to the shippers through the various expansions of Kern River's system, the contract expiration profiles as of November 1, 2004, the end of the adjustment period in the instant proceeding, were as follows:

Original system – 10-year contracts (remaining term of 6 years, 11 months); Original system – 15-year contracts (remaining term of 11 years, 11 months); 2002 Expansion – 10-year contracts (remaining term 7 years, 6 months); 2002 Expansion – 15-year contracts (remaining term 12 years, 6 months); 2003 Expansion – 10-year contracts (remaining term 8 years, 6 months); 2003 Expansion – 15-year contracts (remaining term 13 years, 6 months); and Big Horn Lateral contracts (remaining term 13 years, 2 months). Negotiated rate contracts pertaining to the High Desert Lateral under a traditional depreciation methodology also have a remaining term of 13 years, 2 months.

Opinion No. 486, 117 FERC ¶ 61,077, at n.46 (*citing* Ex. KR-45 at 4, 7).

²⁹⁰ For example, Opinion No. 486, 117 FERC ¶ 61,077 at P 39 (“we hold that in Kern River’s instant rate case, it may and should continue the levelized rate model agreed
(continued...)”)

Commission, in discussing the allocation of risks that parties had agreed to in this proceeding stated “once the Commission has issued the certificate, ‘the Commission will not lightly change the allocation of risk inherent in the optional certificate as granted,’ absent some ‘overarching policy reason.’”²⁹¹ Therefore, the Commission clarifies that that the Period Three rates will be designed in manner consistent with the principles set forth in the instant proceeding.²⁹²

187. Secondly, BP requests that the Period Three rates be restated now consistent with the practice commenced in the original certificate order, and derived using the same principles used in the certificate orders governing the Kern River Original System. BP argues that under Kern River’s ROFR procedures, BP may have to match bids at the maximum rate not just for Period Two, but also those in effect during Period Three for such capacity. BP argues that without stated maximum Period Three rates, the ROFR process will be needlessly contentious.

188. The Commission declines to grant BP’s request. As stated the Period Three rates are to commence at the end of the depreciable life of the Kern River facilities, in approximately another 30 years.²⁹³ The Commission finds that given its findings above

to in its certificate proceeding and subsequent proceedings”); at P 42 (“In the Commission’s view, the depreciation recovery under levelized rates is, by necessity, a long term proposition. . . . it is inherent in any such plan that the levelized rate will remain in effect for the entire agreed upon period.”); at P 44 (“Therefore, the Commission finds that the levelization methodology must remain in place for shippers to realize the benefits bargained for as a part of the refinancing settlement.”)

²⁹¹ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 19 (*citing Mojave Pipeline Co.*, 81 FERC ¶ 61,150 at 61,682-83 (footnote omitted)).

²⁹² This is consistent with the Commission’s determination in Opinion No. 486-A, that:

BP, and all the other parties who agreed Kern River’s levelized rate methodology, should have reasonably anticipated from the beginning that [the levelized] methodology would continue in effect throughout Kern River’s life, absent agreement by all parties to modify or eliminate that rate design. Nor should it come as any surprise to the parties that the Commission would hold the parties to their agreement.

Opinion No. 486-A, 123 FERC ¶ 61,056 P 19.

²⁹³ The Commission uses the economic life of the pipeline in determining depreciation. In this proceeding, the Commission affirmed the holdings of the ALJ
(continued...)

that the Period Three rates will be designed in a manner consistent with the principles set forth in the instant proceeding, it is unnecessary and burdensome to require that rates which are to begin as far in the future as the Period Three rates be incorporated into the Kern River's tariff at this time.

189. Currently, shippers pay rates in Period One until the end of their respective contracts upon which Period Two rates commence. While the Period Two rates are yet to take effect, such rates will commence for the 10 and 15 year shippers when current contracts terminate within two to eight years. The Commission found that Kern River's rate proposal did not provide adequate assurances that its shippers would obtain the benefit of the lower Period Two rates if they continued service beyond the terms of their existing contracts. Because the Commission viewed the opportunity for shippers to obtain the lower Period Two rates upon the expiration of their existing contracts as a vital component of the levelization methodology proposed by Kern River,²⁹⁴ and because the Commission concluded that the makeup of the Period Two rates would be more transparent, the Commission concluded that the implementation of the Period One rates without the benefit of the stepdown Period Two rates being included in Kern River's tariff was unjust and unreasonable.²⁹⁵

190. The circumstances faced by the Commission with regard to the Period Three rates differ from those surrounding its decision to include the Period Two rates in Kern River's tariff. First, in the prior decision the Period Two rates were the next set of rates to take effect and were directly affected by decisions taken for calculation of the Period One rates. Here, the Period Three rates will take effect only after Period Two is completed.

concerning the 35-year remaining economic life of the rolled-in transmission system (calculated from the October 31, 2004, end of the test period in this proceeding). The Commission also adopted recommendations resulting from a finding of a 35-year economic life including an average remaining economic life of 30.6 years for the original system and 27.0 years for the 2002 expansion. Opinion No. 486 at P 410-443.

²⁹⁴ The Commission stated that its:

original and subsequent approvals of the levelized methodology for Kern River were premised on the eventual availability of the step-down of rates bargained for by the shippers. In the instant proceeding, this step-down benefit of the lower Period Two rate remains an essential component of Kern River's proposal.

Opinion No. 486, 117 FERC ¶ 61,077 at P 54.

²⁹⁵ Opinion No. 486-A, 123 FERC ¶ 61,056, at P 62.

Therefore, the Period Three rates are not the next set of rates to be imposed upon the shippers. In the Commission's view, forecasting the rates as far in the future as required to include Period Three rates in the tariff (approximately 30 years) does not yield the benefits it saw in requiring that the Period Two rates be included in the tariff. The Commission finds that under these circumstances, inclusion of the Period Three rate requires far too much speculation such as, for example, whether a management fee will be necessary at the end of Kern River's depreciable life.

191. Accordingly, the Commission finds that it is not necessary to include the future Period Three rates in Kern River's tariff. Moreover, the Commission finds that BP's argument that it is necessary to know rates far in the future in order that the ROFR process will not be needlessly contentious is not persuasive. First, any ROFR process may include time periods for which rates are not currently known. It is the Net Present Value based on the maximum rate currently in effect that controls the allocation of capacity. Secondly, given the speculation in forecasting rates as far into the future as necessary as for the Period Three rates, in the Commission's view, such action could hardly be less contentious than the ROFR process foreseen by BP.

VIII. Conclusion and Further Filing Requirements

192. The Commission holds that the 12.50 ROE embedded in the rates filed as part Kern River's September 30, 2008 settlement proposal is not just and reasonable. Therefore, the rates at issue are not just and reasonable and the settlement is rejected. BP's request for clarification and rehearing is granted in part and denied in part for the reasons stated in the body of this order. Kern River is therefore, directed to cancel the interim rates filed with the settlement effective October 1, 2008 and to make a revised compliance filing within 45 days after this order issues using a ROE of 11.55 percent to design its compliance filing rates. Comments thereon will be due 75 days after this order issues with reply comments due 90 days after this order issues. Kern River is further directed to recapture the interim refunds previously made at the earliest practical date after this order issues as required by the settlement.

The Commission orders:

(A) The settlement proposal dated September 30, 2008 is rejected as unjust and unreasonable for the reasons stated in the body of this order.

(B) BP's request for clarification and rehearing is granted in part and denied in part.

(C) Kern River shall make a revised compliance filing within 45 days after this order issues conforming to the findings of this order.

(D) Comments on the revised compliance filing are due 75 days after this order issues and reply comments are due 90 days after this order issues.

(E) Kern River shall recapture the refunds previously made under terms of the settlement at the earliest practical date after this order issues.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.