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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Marc Spitzer, Philip D. Moeller,
John R. Norris, and Cheryl A. LaFleur.

Kern River Gas Transmission
Company

Docket Nos. RP04-274-020
RP04-274-017
RP04-274-018
RP04-274-019
RP04-274-016
RP04-274-009
RP04-274-021
RP04-274-022

OPINION NO. 486-D

ORDER ON REHEARING AND COMPLIANCE

(Issued November 18, 2010)

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1. On December 17, 2009, the Commission issued Opinion No. 486-C¹ in this Natural Gas Act (NGA) section 4 case commenced by Kern River Gas Transmission Company (Kern River) in 2004. Opinion No. 486-C denied requests for rehearing of the Commission's holding in Opinion No. 486-B² that Kern River's return on equity (ROE) should be 11.55 percent. Opinion No. 486-C also accepted Kern River's revised compliance filing concerning Kern River's Period One Rates. In addition, Opinion No. 486-C held that Kern River's Period Two Rates must be levelized and established a hearing on other issues concerning the Period Two rates. Finally, Opinion No. 486-C held the hearing in abeyance for settlement judge procedures.

2. This order addresses the requests for rehearing of Opinion No. 486-C filed by Kern River and BP Energy Company (BP) and Kern River's filings to comply with Opinion No. 486-C.

I. Background

3. Given the detail in four prior orders, Opinion No. 486, Opinion No. 486-A, and Opinion No. 486-B, and Opinion No. 486-C, this background is limited to that necessary for the issues now before the Commission.³ To summarize, in January 1990, the Commission issued a certificate for Kern River to construct its Original System under the optional expedited certificate regulations adopted in Order No. 436.⁴ In that order, the Commission approved initial rates based on, among other things, a levelized cost of service and a 25-year depreciation life. The Commission also authorized Kern River to charge separate levelized rates for

¹ *Kern River Gas Transmission Co.*, 129 FERC ¶ 61,240 (2009) (Opinion No. 486-C).

² *Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034 (2009) (Opinion No. 486-B).

³ *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486), *order on reh'g, Kern River Gas Transmission Co.*, 123 FERC ¶ 61,056 (2008) (Opinion No. 486-A), *order on reh'g, Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034 (Opinion No. 486-B), *order on reh'g, Kern River Gas Transmission Co.*, 129 FERC ¶ 61,240 (2009) (Opinion No. 486-C).

⁴ *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069, at 61,150 (1990) (Original Certificate Order).

three different periods: (1) the 15-year term of the firm shippers' initial contracts (Period One); (2) the period from the 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 (Period One Rates) were designed to recover approximately 70 percent of Kern River's original investment, an amount about equal to the portion of its invested capital funded through debt.⁵ Since the Period One Rates allowed Kern River to recover more invested capital during Period One than Kern River would under ordinary straight-line depreciation for the depreciable life of the project, the rates for the second two periods (the Period Two Rates and Period Three Rates) would be lower than the Period One Rates. As the Commission explained in a subsequent order in the original certificate proceeding, "[T]he sudden drop in plant recoveries in year 16 occurs because Kern River's rates are based upon *two levelized calculations, one for the first fifteen years and the other for the next 10 years.*"⁶

4. 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 Extended Term (ET) Settlement).⁷ As a result of the 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 September 30, 2011), while the other group extended their contract terms by 10 years and entered into revised contracts with 15-year terms (October 1, 2001 to September 30, 2016). The ET Settlement provided that the firm shippers' rates under these contracts would be designed consistent with the principles stated in the Original Certificate Order, permitting Kern River to recover 70 percent of the costs of the plant being depreciated by the end of the new repayment periods.⁸

⁵ See Original Certificate Order, 50 FERC ¶ 61,069 at 61,144.

⁶ *Kern River Gas Transmission Co.*, 58 FERC ¶ 61,073, at 61,244 n.38 (1992) (emphasis added)(Amended Original Certificate Order).

⁷ *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061 (2000), *order on reh'g*, 94 FERC ¶ 61,115 (2001).

⁸ *Id.* 61,059.

5. In May 2002, Kern River completed an expansion project by adding additional compression to its system (2002 Expansion).⁹ The costs associated with the 2002 Expansion were rolled into the Original System costs, creating the Rolled-in System. As before, the 2002 Expansion shippers were permitted to choose 10-year or 15-year terms for this additional capacity. In May 2003, Kern River completed another expansion project (2003 Expansion).¹⁰ Kern River priced these services on an incremental basis and again permitted shippers to choose either 10-year or 15-year firm contracts. Therefore, after the 2003 Expansion, there were six groups of levelized rate contracts, and the shippers under all those contracts are still paying Period One Rates.¹¹

⁹ *Kern River Gas Transmission Co.*, 96 FERC ¶ 61,137 (2001) (2002 Expansion Certificate Order).

¹⁰ *Kern River Gas Transmission Co.*, 100 FERC ¶ 61,056 (2002) (2003 Expansion Certificate Order), *order on reh'g*, 101 FERC ¶ 61,042 (2002).

¹¹ The expiration dates of the various contracts are as follows:

Original system – 10-year contracts (expires September 30, 2011); Original system – 15-year contracts (expires September 30, 2016); 2002 Expansion – 10-year contracts (expires April 30, 2012); 2002 Expansion – 15-year contracts (expires April 30, 2017); 2003 Expansion – 10-year contracts (expires April 30, 2013); 2003 Expansion – 15-year contracts (expires April 30, 2018); and Big Horn Lateral contracts (expires 2017). Negotiated rate contracts pertaining to the High Desert Lateral under a traditional depreciation methodology expire in 2017. *See* Ex. KR-45 at 4, line 7-8.

Because Kern River's firm contracts expire on seven different dates, in its April 30, 2004 rate case filing, Kern River proposed different levelized rates for each of the seven groups of contracts. Thus, there are different proposed rates for (1) original firm shippers with 10-year contracts, (2) original firm shippers with 15-year contracts, (3) 2002 Expansion shippers with 10-year contracts, (4) 2002 Expansion shippers with 15-year contracts, (5) 2003 Expansion shippers with 10-year contracts, (6) 2003 Expansion shippers with 15-year contracts, and (7) Big Horn Lateral shippers. The rates of the first four groups of shippers are based on the rolled-in cost of service of the original system and the 2002 Expansion. The

(continued...)

6. On April 30, 2004, Kern River filed the instant general rate case under section 4 of the NGA (Original Rate Case Filing). Kern River proposed to continue using the rate levelization methodology and cost of service rate principles approved in the Original Certificate Order, the ET Settlement, the 2002 and 2003 Expansion Certificate Orders, and prior Kern River rate case settlements,¹² with certain modifications.¹³ BP and Trial Staff, opposed the continuation of Kern River's levelized rate methodology, arguing that it over recovers Kern River's costs during Period One. Most other aspects of Kern River's rate filing were also opposed. After a hearing, the Presiding Administrative Law Judge (ALJ) issued her Initial Decision (ID) on March 2, 2006, approving Kern River's proposal to continue its levelized rate methodology and addressing numerous other cost of service and rate design issues, including Kern River's proposed ROE.¹⁴

7. On October 19, 2006, the Commission issued Opinion No. 486, affirming the ALJ's decision that Kern River should be allowed to continue its levelized rate methodology.¹⁵ The Commission recognized that the Period One Rates will result in Kern River recovering more depreciation expense than it will have depreciated on its books and that at the end of Period One, Kern River's books would reflect a regulatory liability. In order to increase the assurance that Kern River's shippers will obtain the benefit of the resulting lower Period Two Rates if they continue service beyond the terms of their existing contracts, the Commission directed Kern

rates of the 2003 Expansion and Big Horn shippers reflect the incremental costs of their expansion projects.

¹² *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).

¹³ *See* Opinion No. 486, 117 FERC ¶ 61,077 at P 4-17 (providing a detailed history of recent regulatory proceedings regarding Kern River's system). While Kern River previously used this method to levelize its entire cost of service, in this rate case it proposed to exclude compressor and general plant from its levelized rate methodology.

¹⁴ *Kern River Gas Transmission Co.*, 114 FERC ¶ 63,031 (2006).

¹⁵ Opinion No. 486, 117 FERC ¶ 61,077 at P 37.

River to include in its tariff the expected Period Two Rates that would take effect when the existing contracts expired.¹⁶

8. Opinion No. 486 also reversed the ALJ's determination that the proper ROE for Kern River was 9.34 percent, and approved an ROE of 11.2 percent for Kern River based on a proxy group that did not include any master limited partnerships (MLPs).¹⁷ Subsequently, on April 17, 2008, the Commission issued a *Policy Statement* modifying its policy concerning the composition of the proxy groups used to determine ROEs for gas and oil pipelines under the Discounted Cash Flow (DCF) model to permit inclusion of MLPs.¹⁸ On April 18, 2008, the Commission issued Opinion No. 486-A. Recognizing that the Kern River record did not address all of the ROE issues needing examination in light of the *Policy Statement*, Opinion No. 486-A reopened the record for a paper hearing to give all parties an opportunity to submit additional evidence.

9. On September 30, 2008, Kern River filed a settlement proposal (Settlement), together with revised tariff sheets to implement the Settlement rates for the settling parties on an interim basis effective October 1, 2008. On October 28, 2008, the Commission accepted the tariff sheets implementing the reduced Settlement rates on an interim basis, subject to the Commission's decision on the merits of the Settlement.¹⁹

10. On January 15, 2009, the Commission issued Opinion No. 486-B. Based on the record in the paper hearing, Opinion No. 486-B held that Kern River's ROE should be 11.55 percent, and the Commission therefore rejected the Settlement on the ground that its 12.5 percent ROE was too high.²⁰ The Commission also

¹⁶ On December 18, 2006, Kern River submitted a compliance filing in Docket No. RP04-274-008 in accordance with Opinion No. 486. The Commission did not act on this filing because it was superseded by the revised compliance filing Kern River submitted on March 2, 2009. The compliance filing in Docket No. RP04-274-008 is therefore rejected as moot.

¹⁷ Opinion No. 486, 117 FERC ¶ 61,077 at P 2.

¹⁸ *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (2008) (*Policy Statement*).

¹⁹ *Kern River Gas Transmission Co.*, 125 FERC ¶ 61,108 (2008).

²⁰ Opinion No. 486-B, P 23-28, 154-166.

directed Kern River to cancel the interim rates filed with the Settlement and recapture the refunds made under the Settlement as soon as was practical. Opinion No. 486-B required Kern River to submit a compliance filing by March 2, 2009 revising its rates consistent with Opinion Nos. 486, 486-A, and 486-B,²¹ and denied BP's request for rehearing of Opinion No. 486-A.

11. Several parties requested rehearing of Opinion No. 486-B.²² In addition, on January 30, March 2, March 27, and September 22, 2009, Kern River submitted filings to comply with the directives of Opinion No. 486-B.²³ In its March 2, 2009 compliance filing, Kern River stated that the Period One rates required by Opinion No. 486 for all customer classes, other than the 10-year shippers on the Rolled-in System, are lower than the rates in effect before Kern River made its April 30, 2004 NGA section 4 filing in this case. However, Kern River stated that, consistent with NGA section 5, the Commission could not reduce the Period One rates for the non-10-year Rolled-in System shippers below the rates in effect before this rate case until the Commission approved the compliance filing, thereby fixing the new just and reasonable rates to be applied prospectively. Kern River stated that this created a "Locked-in Period" from November 1, 2004 through the date of the Commission's final order in this proceeding, when the revised lower prospective Period One rates required by Opinion No. 486 would take effect. Kern River's March 27 and September 22, 2009 compliance filings made various corrections to earlier compliance filings, without altering the fact that all shippers other than the 10-year Rolled-in System shippers receive a prospective reduction in the Period One rates below the level of their rates prior to this rate case.

²¹ *Id.* P 167-191.

²² BP filed a request for clarification or rehearing of Opinion No. 486-B in Docket No. RP04-274-015. The Rolled-In Customer Group (RCG) filed a request for rehearing of Opinion No. 486-B in Docket Nos. RP04-274-016 and RP00-157-015.

²³ As noted in Opinion No. 486-C, on March 2, 2009, Kern River submitted a revised compliance filing in accordance with Opinion No. 486-B. On March 27, 2009, Kern River submitted a supplemental compliance filing to correct the pagination of two tariff sheets in its March 2, 2009 compliance filing. On September 22, 2009, Kern River filed additional corrections to its March 2, 2009 compliance filing.

12. The Commission issued Opinion No. 486-C on December 17, 2009. In the first portion of that order, the Commission denied the requests for rehearing of Opinion No. 486-B.²⁴ The second portion of Opinion No. 486-C addressed the compliance filings submitted by Kern River. The Commission accepted the tariff sheets listed in Appendix C to Opinion No. 486-C establishing the rates for Period One, subject to conditions. The tariff sheets establishing the Period One Rates for the Locked-in Period were effective as of the dates stated in the tariff sheets. The Commission accepted the tariff sheets establishing the prospective Period One Rates effective on December 17, 2009, the date of the issuance of Opinion No. 486-C. The Commission rejected the tariff sheets listed in Appendix D of Kern River's compliance filing concerning the Period Two Rates.²⁵ The Commission required Kern River to offer levelized rates in Period Two and to file *pro forma* Period Two tariff sheets and established settlement judge procedures and a hearing on the Period Two issues.²⁶

13. BP and Kern River filed requests for rehearing of Opinion No. 486-C. On January 29, 2010, Kern River filed to comply with Opinion No. 486-C's holdings concerning its Period One Rates, and on February 1, 2010, Kern River filed a separate compliance filing concerning its Period Two Rates. Below, we first discuss all pending issues related to Kern River's Period One Rates. We then turn to Kern River's Period Two Rates.

II. Period One Rates

A. Requests for Rehearing

14. Kern River's rehearing requests concerning its Period One rates address the effective date of the reduced prospective Period One rates, the retroactive application of the requirement that the Period One rates be designed based on actual billing determinants, rather than 95 percent of Kern River's design capacity, and the cost allocations between the 10-year and 15-year Rolled-in Shippers. BP requests rehearing regarding the method for allocating accumulated regulatory depreciation and ADIT balances and the proper method for establishing and tracking those balances inside Kern River's accounting system. For the reasons

²⁴ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 15-117.

²⁵ *Id.* P 148 and the discussion of specific issues, P 149-225; P 266.

²⁶ *Id.* P 247-265.

discussed below, the Commission denies all requests for rehearing with respect to Opinion No. 486-C's rulings on Kern River's Period One rates.

1. **The Effective Date of the Period One Rates**

15. In Opinion No. 486-C, the Commission considered the revised compliance filings and revised tariff sheets filed by Kern River on March 2, 2009, March 27, 2009, and September 22, 2009. Opinion No. 486-C accepted the prospective reduction in Kern River's Period One rates below their preexisting level effective December 17, 2009, the date of issuance of Opinion No. 486-C, subject to one condition.²⁷ That condition was that Kern River revise the prospective rates to use the same billing determinants to allocate costs between the 10-year and 15-year Rolled-in System customers, as it used to design the Rolled-in System rates.²⁸ In its compliance filings, Kern River had used the 15-year shippers' actual Original System reservation billing determinants of 639,570 Dth in designing the prospective Period One Rolled-in System rates, including three 15-year Original System contracts for seasonal firm service. However, Kern River had allocated costs to the 15-year shippers based on their 624,416 Dth share of Kern River's Original System design capacity, and excluded the billing determinants related to the three 15-year seasonal contracts.²⁹ Kern River was directed to file revised tariff sheets within 45 days of the issuance of Opinion No. 486-C to comply with this determination.

Kern River's Request for Rehearing

16. Kern River argues the Commission erred in declaring the prospective Period One rates effective December 17, 2009, the date of issuance of Opinion

²⁷ *Id.* at P 148; Ordering Paragraph (B).

²⁸ *Id.* at P 167. In this context, designing the Original System rates means calculating the per unit rates for service on the Original System.

²⁹ *Id.* at P 171. The costs of the 2002 Expansion have been rolled into the Original System Costs, creating what has been referred to as the "Rolled-in System", even though Kern River's shippers have separate contracts for service on the Original System and the 2002 Expansion. Because of the roll-in, Kern River and BP have discussed this allocation issue as involving the allocation of costs between the 10-year and 15-year "Rolled-in System shippers." However, the billing determinants at issue relate solely to the shippers' contracts for service on the Original System.

No. 486-C. Kern River explains that because the Commission accepted Kern River's proposed Period One rates "subject to conditions" in Opinion No. 486-C, and those conditions require changes to various components of the prospective rates, the rates are indeterminable as of the date of the Commission's order. Kern River argues that because the Commission did not "fix" specific new rates as of the date of its order, its ruling that the prospective Period One rates will be effective on December 17, 2009, is not in accordance with law and should be reversed.

17. Kern River states that the United States Court of Appeals for the District of Columbia Circuit has determined what it means for the Commission to "fix" a new rate and when such rate becomes effective in *Electrical District*.³⁰ Kern River explains that the petitioners in *Electrical District* argued that the statute required the exact, new rate to be specified before it could be made effective, while the Commission contended that it had sufficiently determined the new rate to satisfy its statutory obligation. Kern River states that the court found for petitioners, reasoning that customers must know the price of the service they receive before a new rate is "fixed" as provided by the statute, because of the interest in predictable rates.³¹ Therefore, Kern River argues, the Court concluded that the Commission "fixes" a new rate when it accepts the compliance filing that states exactly the utility's new rate. Kern River argues the Commission has applied the principle of *Electrical District* in numerous pipeline rate cases under NGA.³²

18. Kern River asserts that here, the Commission and Kern River's customers cannot know the new rates for Kern River's service that result from the Commission's rulings in Opinion No. 486-C until Kern River computes and files such rates and the Commission accepts them. As a result, Kern River argues that the Commission should grant rehearing and vacate the effective date of December 17, 2009, for Kern River's prospective Period One rates. Kern River states that instead, the prospective rates should be made effective on the date the

³⁰ Kern River's January 19, 2010 Request for Rehearing at 8 (citing *Electrical District No. 1 v. FERC*, 774 F.2d 490 (D.C. Cir. 1985) (*Electrical District*)).

³¹ *Id.*

³² *Id.* (citing *High Island Offshore Sys., L.L.C.*, 113 FERC ¶ 61,280, at P 26 (2005) (*High Island*); *Williston Basin Interstate Pipeline Co.*, 69 FERC ¶ 61,360, at 62,362-363 and n.16 (1994) (*Williston*)).

Commission issues a final order on compliance which “fixes” the exact new rates applicable to Kern River’s services.

Commission Determination

19. The Commission denies Kern River’s request for rehearing on this issue. In Opinion No. 486-C, the Commission held that Kern River’s prospective Period One rates would be effective December 17, 2009, the issuance date of that order. Kern River argues this was an error because the Commission had not yet “fixed” the Period One rates, because Opinion No. 486-C ordered Kern River to submit another compliance filing.

20. When the Commission acts under NGA section 5 to reduce rates below their preexisting level, the rate reduction may only become effective on a prospective basis. NGA section 5 provides that, once the Commission has found a tariff provision unjust and unreasonable, the Commission “shall determine the just and reasonable rate...to be thereafter observed and in force, and shall fix the same by order.”³³

21. The U.S. Court of Appeals for the District of Columbia Circuit examined what it means for the Commission to “fix” a new rate and when that rate becomes effective in *Electrical District*.³⁴ In that case, the court reversed a Commission order that made a new rate effective as of the date the Commission ordered the utility to make a compliance filing, rather than the date on which the Commission accepted the compliance filing. The court stated that making this action effective as of the date of an initial “order setting forth no more than the basic principles pursuant to which the new rates are to be calculated would make unforeseeable liabilities a regular consequence of rate adjustments . . .”³⁵ The court stated that as an alternative to waiting for the pipeline to calculate the rates in a compliance filing, the Commission may calculate and fix the rate itself in the initial order.³⁶

³³ 15 U.S.C. § 717d (2006).

³⁴ *Electrical District*, 774 F.2d 490 (D.C. Cir. 1985).

³⁵ *Id.* at 493.

³⁶ *Id.* at 494.

22. Since *Electrical District*, the Commission's general practice in determining the effective date of rate changes ordered pursuant to NGA section 5 has been to follow the approach suggested by the court in that case. Therefore, the Commission either calculates the new just and reasonable rate itself, or orders the pipeline to calculate the revised rate in its compliance filing. If the Commission requires the pipeline to make a compliance filing, the Commission makes the section 5 rate change effective on the date the Commission issues an order accepting the pipeline's initial compliance filing, thereby "fixing" the new just and reasonable rate.³⁷ The Commission does this, even if its acceptance of the initial compliance filing is subject to the pipeline making a second compliance filing to correct errors in its first compliance filing.³⁸

23. Kern River asserts the Commission's decision in Opinion No. 486-C ordering the prospective Period One rates to be effective as of the date of that order is inconsistent with *Electrical District*. The Commission disagrees. In *Electrical District*, the court explained that rates are fixed when the Commission issues an order accepting the compliance filing. The rationale behind the court's decision was to avoid rate uncertainty³⁹ and protect customers.⁴⁰

24. Here, Opinion No. 486-C was the order where the Commission accepted Kern River's compliance filing. The Commission had already issued three orders making merits rulings on Kern River's proposed Period One rates in this proceeding, starting with Opinion No. 486 issued over three years earlier on October 19, 2006. In Opinion No. 486-B, the Commission directed Kern River to submit a revised compliance filing revising its Period One rates consistent with

³⁷ *High Island*, 113 FERC ¶ 61,280 at P 26; *Williston*, 59 FERC ¶ 61,202, at 61,716-717 (1992), *order on remand*, 68 FERC ¶ 61,357, *reh'g denied*, 69 FERC ¶ 61,360, at 62,362-363 and n.16 (1994).

³⁸ *See Williston*, 59 FERC at 61,717, in which the Commission accepted a Section 5 compliance filing effective on the date of the order accepting the filing, subject to *Williston* making a further compliance to remove an unauthorized rate design change.

³⁹ *Electrical District*, 774 F.2d at 493-494 (stating "Providing the necessary predictability is the whole purpose of the well established 'filed rate doctrine'").

⁴⁰ *Id.* at 494 (stating "we think the provision [section 206] must be read in light of the Federal Power Act's primary purpose of protecting the utility's customers.").

Opinion Nos. 486, 486-A, and 486-B. On March 2, March 27, and September 22, 2009, Kern River submitted the required compliance filings, and the Commission accepted those filings, subject to conditions in Opinion No. 486-C. Thus, it was appropriate for the Commission to make the Period One rates effective as of the date of Opinion No. 486-C, its first order accepting Kern River's compliance filings concerning its Period One rates.

25. Kern River argues that, because Opinion No. 486-C accepted the prospective Period One rates conditionally and ordered Kern River to submit another compliance filing, the rates were not fixed. However, the changes the Commission ordered in Opinion No. 486-C were limited. The Commission directed Kern River to make one change: to use different reservation determinants for allocating costs between 10-year and 15-year Rolled-In Shippers. This was a mechanical change that involved substituting one number for another and did not permit any discretion on the part of the pipeline. Specifically, the Commission directed Kern River to use the 15-year shippers' actual Original System reservation billing determinants of 639,570 Dth to allocate costs between the 10- and 15-year Rolled-in System shippers, as well as for the purpose of designing per-unit rates for those shippers.

26. In *Electrical District*, the court, wanting to avoid rate uncertainty, stated that an order setting forth "no more than the basic principles" for calculating new rates does not "fix" a rate.⁴¹ However, here, the Commission had done much more than set forth the basic principles of Kern River's Period One rates by the time it issued Opinion No. 486-C. The Period One rates had been calculated in Kern River's compliance filing, which the Commission accepted in Opinion No. 486-C, with one limited change. Thus, the rate uncertainty that concerned the court in *Electrical District* was not present here to the same degree.

27. Additionally, no shippers allege any harm from the Commission's decision to make the Period One rates effective as of the date of Opinion No. 486-C. Rather, the effective date set by the Commission benefits shippers, which may explain why Kern River is the only party that objects to the decision. By protecting shippers, the Commission's decision in Opinion No. 486-C is consistent with the rationale underlying *Electrical District*, which was that the Federal Power Act (FPA) or, here, the NGA and the filed rate doctrine were created "for the primary purpose of protecting the utility's customers."⁴²

⁴¹ *Id.* 493.

⁴² *Id.*

28. Moreover, since *Electrical District*, the court has suggested that the Commission's ability to fix prospective rates under NGA section 5 is not as constrained as Kern River asserts. In *Transwestern*, the court clarified *Electrical District* and held that the "Commission need not confine rates to specific, absolute numbers but may approve a tariff containing a rate 'formula' or rate 'rule.'"⁴³ The change ordered by the Commission in Opinion No. 486-C is analogous to the situation contemplated in *Transwestern* because, like a formula or a rule, it left Kern River no discretion as to how to implement the modification. The Commission simply directed that Kern River utilize a different number to allocate costs to the 15-year Rolled-in System shippers. Thus, consistent with *Transwestern*, the Commission's decision in Opinion No. 486-C was well within its NGA section 5 authority to fix rates to be effective prospectively from the date of that order.

29. The Commission's decision in Opinion No. 486-C is also consistent with the other cases cited by Kern River. In *Williston*, the Commission relied on *Electrical District* to find that its order accepting the pipeline's section 5 compliance filing subject to a further compliance filing⁴⁴ fixed the proper prospective effective date. *Williston* appealed the Commission's underlying section 5 action, and the Commission requested a voluntary remand.⁴⁵ In its order on remand, the Commission reaffirmed its earlier orders.⁴⁶ On rehearing, *Williston* contended that the section 5 action could not be made effective before the order on remand. The Commission rejected this contention. The Commission explained that "the Commission's later order could lawfully support its earlier action without effecting a change in the effective date of that action, for example, in the same way the Commission acts on rehearing."⁴⁷ The Commission further stated that "to require the effective date of a section 5 action to be deferred until the very last word has been spoken in response to arguments made by the

⁴³ *Transwestern Pipeline Co. v. FERC*, 897 F.2d 570 (D.C. Cir. 1990) (*Transwestern*).

⁴⁴ *Williston*, 59 FERC at 61,716-717.

⁴⁵ *Williston*, 69 FERC ¶ 61,360 at 62,362-363.

⁴⁶ *Williston*, 68 FERC ¶ 61,357 (1994).

⁴⁷ *Id.* 62,363.

company would seriously weaken, if not destroy, the Commission's power to act under section 5."⁴⁸

30. The reasoning in *Williston* is applicable here. Though Kern River suggests the Commission's policy should be to wait until the very last compliance filing has been accepted to fix the proper prospective effective date, that approach is unreasonable because it would give the pipeline an improper incentive to delay resolution of the proceeding as long as possible by never getting its compliance filing quite right.

31. In *High Island*, also cited by Kern River, the Commission agreed with the pipeline that the effective date of a section 5 modification was fixed by an order accepting the pipeline's first compliance filing, and not by an earlier order on initial decision.⁴⁹ The holding in *High Island* is consistent with the Commission's actions in this proceeding. Here, the Commission is not attempting to make the Period One rates effective as of the date of Opinion No. 486 (the order on initial decision in this proceeding), but as of the date over three years later when the Commission first accepted the pipeline's compliance filings in Opinion No. 486-C, just as the Commission did in *High Island*. Accordingly, the Commission finds that the precedent cited by Kern River does not bar the prospective Period One rates from going into effect on December 17, 2009. The Commission denies Kern River's request for rehearing on this issue.

2. **Retroactive Elimination of 95 Percent Load Factor**

32. In this rate case, Kern River proposed to design its Original System rates using reservation and usage billing determinants based on 95 percent of the design capacity of its Original System, despite the fact that during the test period it had firm contracts (including several seasonal contracts) for somewhat more than 100 percent of the design capacity of the Original System. Kern River contended that this proposal was consistent with the so-called 95 percent load factor condition in its Optional Expedited Certificate. It asserted that condition required it to design the Original System rates based on 95 percent of design capacity regardless of whether it had contracts for more or less than 95 percent of its capacity. In Opinion Nos. 486 and 486-A, the Commission held that the

⁴⁸ *Id.*

⁴⁹ *High Island*, 113 FERC ¶ 61,280 at P 26-27.

95 percent load factor condition simply required that Kern River design its original system rates based upon *at least* 95 percent of its design capacity.

33. In reaching this conclusion, the Commission pointed out that the same certificate order imposing the 95 percent load factor condition also required Kern River to make a tariff filing three years after its in-service date using “the same *or greater* throughput levels on which Kern River’s initial rates have been predicated.”⁵⁰ The Commission also explained that its interpretation of the 95 percent load factor condition was consistent with section 157.103(d)(3) of the optional expedited certificate regulations. That section provided, “Any rate filed for new service must be designed to recover costs on the basis of projected units of service. The units projected for the new service in the initial rates filed under this subpart may be increased in a subsequent rate filing but may not be decreased.” Thus, the optional expedited certificate regulations expressly required that rates be designed based on projected units of service, subject only to the proviso that rate design volumes not be “decreased” below the level set in the certificate.

34. In its March 2, 2009 compliance filing, Kern River proposed to implement Opinion No. 486’s holding concerning the 95 percent load factor condition on a prospective only basis. Thus, it calculated refunds for the Locked-in Period (commencing November 1, 2004) based on billing determinants equal to only 95 percent of the design capacity of the Original System. Kern River based its actions on its determination that, because it was not proposing a change to its 95 percent load factor rate design approved in the Original Certificate Proceeding, the Commission’s order in Opinion No. 486 may only be implemented in accordance with section 5(a) of the NGA. Therefore, Kern River argued that any rate design changes should be applied on a prospective basis.

35. In Opinion No. 486-C, the Commission rejected Kern River’s contentions and found that Kern River’s rates for the Locked-in Period, commencing November 1, 2004, must be designed based on projected units of service, as required by Opinion No. 486, subject only to the refund floor established by the rates in effect before this rate case. The Commission stated that when a pipeline files a rate increase under NGA section 4, the pipeline bears the burden of proving the justness and reasonableness of its proposed increase.⁵¹ This burden includes

⁵⁰ *Kern River Gas Transmission Co.*, 50 FERC at 61,151 (emphasis supplied).

⁵¹ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 156 (citing *Dominion Transmission Inc.*, 93 FERC ¶ 61,272, at 61,881 (2000)).

proving that all of the cost and throughput components of the rate increase in the filing are just and reasonable under NGA section 4, even when the pipeline has not proposed to change certain of those components.⁵² Given these principles, the Commission reasoned that, if the pipeline fails to satisfy its burden with respect to any of these components, the Commission can require its holding with respect to that component to take effect retroactively to the date the filed rates were suspended and placed into service, subject to refund.

36. The Commission rejected Kern River's assertion that in this rate case it had simply proposed to continue to apply the same 95 percent load factor condition approved in the Original Certificate Proceeding, finding that such an argument was directly contrary to the Commission's holdings in Opinion Nos. 486 and 486-A. The Commission stated that in these Opinions it found that nothing in the Original Certificate Orders supported Kern River's assertion that the 95 percent load factor condition capped its rate design volumes.⁵³

37. Opinion No. 486-C found that Kern River had not met its burden to prove under NGA section 4 that the use of its proposed billing determinants equal to 95 percent of the capacity of its Original System to design its rates was just and reasonable and not unduly discriminatory. Therefore, the Commission found that that Kern River's rates must be designed using projected units of service, as required by Opinion No. 486, commencing on November 1, 2004, the date the Commission accepted and suspended, subject to refund, the rates in this proceeding. The Commission also stated that its ruling was subject to the condition that Kern River need not reduce its rates for any customer class for the period prior to the date of issuance of Opinion No. 486-C below those approved in Kern River's last rate case.⁵⁴

⁵² Opinion No. 486-C, 129 FERC ¶ 61,240 at P 156 (*citing Northern Border Pipeline Co.*, 89 FERC ¶ 61,185, at 61,575 (1999). *See also Northwest Pipeline Corp.*, 92 FERC ¶ 61,287, at 62,012 (2000)).

⁵³ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 157 (*citing* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 75).

⁵⁴ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 158.

Kern River's Rehearing Request

38. Kern River objects to what it asserts is the Commission's retroactive elimination of Kern River's practice of designing rates for the Original System based on a 95 percent load factor.

39. Kern River asserts that in its 2009 compliance filings, it implemented, on a prospective basis, the Commission's directive to use actual test period reservation quantities, including seasonal contract determinants, for purposes of designing the Original System rates. However, Kern River states that in Opinion No. 486-C, the Commission rejected Kern River's proposal to make this change prospectively, and required Kern River to refile its rates for the Locked-In Period using actual test period determinants, commencing November 1, 2004. Kern River argues that the Commission's requirement that Kern River change its historic practice retroactively constitutes legal error.

40. Kern River states that an existing rate or rate practice is presumptively just and reasonable and can be changed by the Commission only upon a finding that the existing rate is unjust and unreasonable and the proposed new rate is just and reasonable.⁵⁵ Kern River states that where the Commission successfully discharges this dual burden, any ordered change may take effect on a prospective basis only.

41. Kern River states that regardless of how the Commission now interprets the 95 percent load factor rate design condition of Kern River's original Optional Certificate, it is undisputed that Kern River historically designed rates using a 95 percent load factor for Original System service and maintained that practice in its proposed rates in this proceeding. Kern River asserts that the Commission's directive that Kern River use actual test period determinants to design the Original System rates is a change to Kern River's historic practice and contrary to Kern River's filed proposal. As such, Kern River contends it can only be imposed by the Commission on a prospective basis, consistent with section 5 of the NGA.

42. Kern River states that throughout this proceeding, it has maintained that the 95 percent load factor rate design condition is properly understood – and has historically operated since the Original Certificate Order – as a true (i.e., two-way) risk-allocation mechanism. Kern River states that in support it argued, and the Commission acknowledged, that the 95 percent load factor condition “was

⁵⁵ Kern River's January 19, 2010 Request for Rehearing at 11 (citing *ANR Pipeline Co.*, 771 F.2d 507, 514 (D.C. Cir. 1985)).

intended to ensure compatibility in rate terms and conditions between Kern River and its then-principal rivals, Mojave Pipeline Company and Wyoming-California Pipeline Company.”⁵⁶ Kern River states that to that end, all three pipelines were subject to the same 95 percent rate design condition, thereby putting the pipelines at comparable risk for any unsubscribed capacity below the 95 percent level required for rate design purposes.

43. Kern River states that in a 1997 section 4 rate case involving Mojave, the Commission considered the identical question at issue here, i.e., whether the 95 percent condition was intended to operate strictly as a floor for billing determinants, or whether, as part of the “risk allocation” under the optional certificate, the pipeline’s downside risk for unsubscribed capacity was subject to counter-balancing, upside rewards to the extent the pipeline achieved subscription in excess of 95 percent of design capacity. Kern River states that the Commission’s response to this question was unequivocal when it stated, “[T]he reciprocal of that [downside/under-subscription] risk is that if Mojave is able to sell more than 95 percent of its capacity, then it is normally entitled to keep the balance for the term of the contracts.”⁵⁷

44. Kern River states that notwithstanding that it had previously decided the identical issue and applied the 95 percent condition as the two-way street that Kern River had consistently understood and applied it to be, the Commission held that the original Optional Certificate orders,⁵⁸ and then-effective regulations governing optional certificates, required Kern River to use actual test period throughput volumes in calculating its proposed rates. Kern River states that in the Commission’s view, continued reliance on the 95 percent condition, as interpreted by Kern River, would “change a key part of the original risk sharing agreement over the objection of Kern River’s shippers.”⁵⁹

45. Kern River states that missing from the Commission’s discussion, however, is any empirical evidence that would support the Commission’s interpretation of

⁵⁶ *Id.* at 14 (citing Opinion No. 486-A, 123 FERC ¶ 61,056 at P 63).

⁵⁷ *Id.* (citing *Mojave Pipeline Co.*, 83 FERC ¶ 61,267, at 62,113 (1998) (*Mojave*)).

⁵⁸ *Id.* at 15 (citing *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069 (1990), *order on rehearing*, 51 FERC ¶ 61,195 (1990) (certificate orders)).

⁵⁹ *Id.* (citing Opinion No. 486-A, 123 FERC ¶ 61,056 at P 81).

the “original risk sharing agreement.” Kern River states that in fact, the evidence offered cuts against the Commission’s conclusion regarding the parties’ original intentions. First, Kern River states that its witness Warner testified that from the outset, Kern River understood the load factor condition as a risk-reward mechanism that provided Kern River the possibility of upside return in the event capacity subscriptions exceeded the 95 percent load factor design level,⁶⁰ and that none of the Original Shippers offered any evidence contradicting this interpretation. Second, Kern River argues that the Commission’s own pronouncements of the 95 percent load factor condition, to the extent that they could arguably inform the parties’ understanding of the condition, likewise contradicts the Commission’s findings in Opinion No. 486-C.⁶¹ Finally, Kern River states that both BP and Rolled-in Customer’s Group acknowledge that requiring Kern River to design rates using test period actual reservation quantities is a change in Kern River’s long-standing application of the 95 percent load factor condition.⁶² Kern River further states that the Commission itself viewed the condition the same way as Kern River in the context of Kern River’s Order No. 636 compliance filing.⁶³

46. Kern River states that nevertheless, the Commission directs Kern River to re-file its rates based on test period actual reservation quantities, effective November 1, 2004, without any mention of the Commission’s repudiation of *Mojave* in Opinion Nos. 486 and 486-A. Kern River argues the Commission cannot impose a change in billing determinants based on a new interpretation of precedent it agrees is consistent with Kern River’s filing in this case and yet require its change to take effect retroactively. Kern River asserts that such a result blurs the line between NGA sections 4 and 5.⁶⁴ Consequently, Kern River argues

⁶⁰ *Id.* (citing Ex. No. KR-23 at 53).

⁶¹ *Id.* at 15-16 (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at P 80 (stating that to the extent “*Mojave* may interpret the 95 percent load factor condition in *Mojave* and Kern River’s optional certificates as capping their rate design volumes at the 95 percent level, we are not following that precedent because it is incorrect.”)).

⁶² *Id.* at 16 (citing BP’s March 31, 2009 Comments and Protest at 6; RCG’s March 31, 2009 Comments at 5).

⁶³ *Id.* (citing *Kern River Gas Transmission Co.*, 64 FERC ¶ 61,049, at 61,418 (1993)).

⁶⁴ *Id.* at 17 (citing *Pub. Serv. Comm’n v. FERC*, 866 F.2d 487, 491 (1989)).

the Commission should reverse its ruling and hold that the required change in rate design shall be effective prospectively.

Commission Determination

47. The Commission denies Kern River's request for rehearing on this issue. For the reasons discussed below, the Commission again finds that the 95 percent load factor condition established in Kern River's optional expedited certificate proceeding was only a floor on the rate design volumes to be used in designing its Original System rates, not a ceiling. In addition, Kern River's rates in effect prior to this rate case were not designed in a manner that would allow it to retain all Original System revenues obtained by selling more than 95 percent of that system's design capacity. Therefore, Kern River's proposal to design its Original System rates in this case based on volumes equal to 95 percent of design capacity did not continue some previously approved or existing rate design methodology. As a result, Kern River had the burden under NGA section 4 of supporting the change it proposed, which contributed to the overall rate increase in Kern River's section 4 filing. Kern River having failed to satisfy that burden, Opinion No. 486-C properly applied its holdings retroactively and directed Kern River to use actual test period reservation quantities on a retroactive basis. By issuing this directive, the Commission was simply rejecting Kern River's proposed change under NGA section 4 and ordering Kern River to comply with the rate design principles set forth in its certificate orders.

48. As we have explained in prior orders, the 95 percent load factor condition was originally established in Kern River's optional expedited certificate proceeding.⁶⁵ In Opinion Nos. 486 and 486-A, the Commission interpreted this condition as creating only a floor on billing determinants, i.e., Kern River's billing determinants may not be any lower than 95 percent of its design capacity. Opinion No. 486 explained that the 95 percent load factor condition requires Kern River to calculate its Original System rates based upon *at least* 95 percent of its design capacity.⁶⁶ Opinion No. 486 further clarified that because the 95 percent

⁶⁵ See *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069, at 61,151 (1990).

⁶⁶ Opinion No. 486, 117 FERC ¶ 61,077 at P 77-84, Opinion No. 486-A, 123 FERC ¶ 61,056 at P 75; Opinion No. 486-C, 129 FERC ¶ 61,240 at P 158, 167.

load factor condition only established a floor on Kern River's rate design volumes, Kern River's rates should be derived "based on projected units of service."⁶⁷

49. The Commission's interpretation of that 95 percent load factor condition was based on a review of Kern River's certificate orders, as well as the regulations that were in effect when Kern River's optional expedited certificate was issued. In Opinion No. 486-A, the Commission explained that nothing in the certificate orders support Kern River's assertion that the 95 percent load factor condition capped its rate design volumes.⁶⁸ Rather, the optional certificate order states that Kern River's next "[tariff] filing must use the same *or greater* throughput levels on which Kern River's initial rates have been predicated."⁶⁹

50. Additionally, in the order granting Kern River's certificate, the Commission stated that it had examined Kern River's application based on the optional expedited certificate regulations.⁷⁰ Those regulations required that such certificates include a floor on the rate design volumes to be used to design the pipeline's rates in future rate cases as a means of ensuring that the pipeline assumed the risk of the project. The regulations did not provide for any cap on the rate design volumes in order to give the pipeline a reciprocal opportunity to increase its profits above the return allowed in its rates. In fact, the regulations expressly permitted an increase in rate design volumes in subsequent NGA section 4 rate cases.⁷¹ Opinion Nos. 486 and 486-A concluded that if the Commission had

⁶⁷ Opinion No. 486, 117 FERC ¶ 61,077 at P 84.

⁶⁸ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 75.

⁶⁹ *Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069, at 61,150-151 (1990) (emphasis added).

⁷⁰ *Id.* 61,149.

⁷¹ Section 157.103(d)(3)(1987) of the Commission's then-effective optional expedited certificate regulations provided:

Any rate filed for new service must be designed to recover costs on the basis of projected units of service. The units projected for the new service in the initial rates filed under this subpart *may be increased in a subsequent rate filing but may not be decreased* [emphasis added].

intended in the orders certificating Kern River's Original System to depart from this aspect of the optional certificate regulations and permit Kern River to design its rates based upon 95 percent of its design capacity, even when its projected units of service exceeded that level, the Commission would have more precisely stated that intent.⁷²

51. On rehearing, Kern River does not provide any facts or point to any language in the certificate orders disputing our interpretation of the 95 percent load factor condition. Nor does Kern River contest the interpretation in Opinion Nos. 486 and 486-A of the then-effective optional certificate regulations. Rather, Kern River relies on events that happened after the certificate orders. However, in doing so, Kern River has been unable to demonstrate that the Commission subsequently changed the parameters of the 95 percent load factor condition established in Kern River's certificate orders. Events since the certification of this project simply do not provide support to Kern River's interpretation of the condition.

52. For example, Kern River points to a 1998 order issued about six years after the optional expedited certificate orders in a section 4 case filed by Mojave Pipeline Company. Mojave was granted its optional expedited certificate in the same orders that issued Kern River's certificate. Kern River asserts that this order supports its position because in *Mojave*, the Commission stated that "the reciprocal of that risk [of the 95 percent load factor condition] is that if Mojave is able to sell more than 95 percent of its capacity, then it is normally entitled to keep the balance for the term of the contracts."⁷³

53. The Commission fully addressed the *Mojave* order in Opinion No. 486-A when it explained that "to the extent that the above quoted passage from *Mojave* may interpret the 95 percent load factor condition in *Mojave* and Kern River's optional certificates as capping their rate design volumes at the 95 percent level, we are not following that precedent, because it is incorrect."⁷⁴ The Commission

⁷² Opinion No. 486, 117 FERC ¶ 61,077 at P 79; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 77.

⁷³ *Mojave*, 83 FERC ¶ 61,267 at 62,113 (1998).

⁷⁴ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 78-86.

may depart from its precedent so long as it provides a reasoned explanation why it is changing course.⁷⁵

54. In Opinion No. 486-A, the Commission explained that the *Mojave* order failed to recognize that the optional certificate order stated that both Mojave and Kern River's next "[tariff] filing must use the same *or greater* throughput levels on which Kern River's initial rates have been predicated," thus clearly indicating that the 95 percent load factor condition did not cap the pipeline's rate design volumes.⁷⁶ Moreover, the 1998 *Mojave* order did not recognize that the optional expedited certificate regulations expressly provided that the volumes used to design the pipeline's initial rates in the certificate proceeding "may be increased in a subsequent rate filing but may not be decreased." Thus, Opinion No. 486-A concluded that *Mojave's* suggestion that pipelines certificated under the optional expedited certificate regulations need not lower their rates to reflect increased billing determinants was contrary to the optional expedited certificate regulations.⁷⁷

55. In Opinion No. 486-A, the Commission further explained that the risk-sharing arrangement approved as part of the optional certificate order should be maintained in subsequent rate cases, absent agreement by all parties to a change.⁷⁸ The Commission stated that to follow *Mojave's* incorrect interpretation of the 95 percent load factor condition in this case would be inconsistent with that principle, since it would change a key part of the original risk-sharing arrangement over the objection of Kern River's shippers.⁷⁹

56. Kern River also points to certain statements by the Commission in Kern River's Order No. 636 restructuring proceeding to suggest the Commission

⁷⁵ See *ANR Pipeline Co. v. FERC*, 71 F.3d 897, 901 (D.C. Cir. 1995). See also *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852, (D.C. Cir. 1970) (agencies departing from their own precedent must "supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored").

⁷⁶ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 78-86.

⁷⁷ *Id.*

⁷⁸ *Id.* P 81.

⁷⁹ *Id.*

viewed the 95 percent load factor condition the same way as Kern River.⁸⁰ However, the language cited by Kern River is mere dicta concerning Kern River's then-pending rate case in Docket No. RP92-226-000. At that time, the Commission did not actually review the certificate orders or interpret the 95 percent load factor condition. Rather, the focus in the restructuring order cited by Kern River was whether costs should be allocated to interruptible service (IT) and the Commission required crediting of most IT revenues. Thus, the statements in the Order No. 636 proceeding simply do not support Kern River's interpretation of the 95 percent load factor condition established in the certificate proceeding.

57. On rehearing, Kern River also argues that from the outset, it understood the load factor condition as a risk-reward mechanism that provided Kern River the upside returns in the event capacity subscriptions exceeded the 95 percent load factor design level.⁸¹ Kern River further states that other parties recognized in their pleadings that requiring Kern River to design rates using test period actual reservation quantities is a change to Kern River's long-standing application of the 95 percent load factor condition.⁸²

58. However, Kern River's statements about what it understood the 95 percent load factor condition to be are not controlling. Nor do other parties' statements in their pleadings have any bearing on interpreting the load factor condition as established in the certificate order. What governs here is the clear and unambiguous language in Kern River's original optional expedited certificate proceeding orders, which, as explained above, does not support Kern River's assertion that the 95 percent load factor condition capped its rate design volumes for the Original System. As shown below, even Kern River's professed understanding of the 95 percent load factor conditions is, at times, flexible.

59. Kern River next argues that, regardless of how the Commission now interprets the 95 percent load factor rate design condition in Kern River's optional expedited certificate, Kern River has an established past practice of designing its Original System rates based on 95 percent of its design capacity, and in this rate

⁸⁰ *Id.* (citing *Kern River Gas Transmission Co.*, 64 FERC ¶ 61,049, at 61,418 (1993)).

⁸¹ Kern River's January 19, 2010 Request for Rehearing at 15.

⁸² Kern River's January 19, 2010 Request for Rehearing at 16 (citing BP Energy Co.'s March 31, 2009 Comments and Protest at 6; RCG's March 31, 2009 Comments on Revised Compliance Filing at 5) .

case it simply proposed to continue that practice. Therefore, Kern River argues that the Commission's directive that Kern River use actual test period determinants to design the Original System rates is a change to this historic practice and contrary to Kern River's filed proposal.

60. The Commission disagrees. Kern River has had two rate cases since the time of its original certificate proceeding. A review of the outcome of those cases contradicts Kern River's claim that those cases established a practice of treating the 95 percent load factor condition as a ceiling on the Original System rate design volumes, contrary to our interpretation of that condition. In the first place, both of those section 4 rate cases ended in uncontested settlements,⁸³ and both settlements contained provisions stating that they did not establish any principles concerning Kern River's rates.⁸⁴ Nowhere in the orders approving the settlements did the Commission address the relationship between the billing determinants in the settlements and Kern River's actual billing determinants or its design capacity. Thus, neither the Commission orders approving the settlements, nor the settlements themselves, modified the condition set forth in the certificate orders. To interpret the settlements as establishing a rate design principle for Kern River's

⁸³ See *Kern River Gas Transmission Co.*, 70 FERC ¶ 61,072 (1995). See also *Kern River Transmission Gas Co.*, 87 FERC ¶ 61,128 (1999), *order on reh'g*, 88 FERC ¶ 61,261 (1999), *order on reh'g*, 98 FERC ¶ 61,245 (2002).

⁸⁴ See *Kern River Gas Transmission Co.*, 70 FERC ¶ 61,072, at 61,178 (1995) (stating that section 4 of the settlement in Docket No. RP92-226-000, *et al.*, expressly provides that the Appendix B schedules shall not establish any principles or precedents involving Kern River's rates (or components thereof) and shall not be cited or used in connection with any other proceeding). See also Article XVI, Section 2 of Kern River's March 31, 1999 Settlement in Docket No. RP99-274-000, *et al.* (stating that "[t]he Commission's approval of this Settlement shall constitute a finding that the Settlement is fair and reasonable and in the public interest for the purposes of settlement, but shall not be a determination on the merits of the specific provisions of the Settlement, either jointly or severally. Neither Kern River, the Commission, its Staff, the Kern River Customers nor any other party or person shall be prejudiced or bound by the Settlement in any other proceeding."). In addition, section 10 of a letter of intent attached to the March 31, 1999 Settlement states, "This is a black box Settlement which has been derived based upon an agreement as to the overall rate to be charged by Kern River. As such, when approved it will have no precedential value as to how specific components of the rate or rate design should be derived."

rates that billing determinants should be capped at 95 percent of design capacity would be contrary to the express provision in those settlements that they established no principles concerning Kern River's rates.

61. Second, in the most recent rate case settlement, Kern River's rates were designed based upon volumes somewhat in excess of 95 percent of its capacity, contrary to Kern River's assertion of a past practice of designing its rates based upon 95 percent of capacity.⁸⁵ Moreover, the most recent rate case settlement also required Kern River to provide revenue credits if its revenues went above a certain level.⁸⁶ This also contradicts Kern River's assertion that its rates have been designed in a manner to allow it to keep all profits resulting from selling more than 95 percent of its design capacity.

62. Therefore, in this rate case, Kern River is not proposing to continue an existing practice of designing its rates based upon 95 percent of its design capacity. Rather, it is proposing to reduce its rate design volumes below the level underlying its settlement rates approved in its last case and to eliminate the revenue crediting mechanism approved in the last settlement. Thus, Kern River is proposing rate design volumes that are contrary to the rate design methodology approved in the optional expedited certificate and contrary to methodology used in its last rate case.

63. Because Kern River's proposed rate design volumes for the Original System do not continue some previously approved or existing rate design methodology, it had the burden under NGA section 4 to support its proposed rate design volumes as one of the component elements underlying its proposed overall

⁸⁵ As pointed out by the Commission in Opinion No. 486-A, Kern River stated that, in the 1995 settlement of its Docket No. RP92-226-000 section 4 rate case and the 1999 settlement of its Docket No. RP99-274-000 rate proceeding, the parties agreed to design its rates using reservation billing determinants equal to 96 percent of its Original System's design capacity. These billing determinants were included in workpapers filed with the settlements which "set forth an illustrative cost of service and billing determinants reflecting one method of deriving Settlement rates." See *Kern River Gas Transmission Co.*, 70 FERC ¶ 61,072 at 61,178 (1995); *Kern River Gas Transmission Co.*, 87 FERC ¶ 61,128 (1999); Ex. KR-17 at 15. The 2000 ET Settlement provided for continued use of those same billing determinants. *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061, at 61,157 (2000). Opinion No. 486-A, 123 FERC ¶ 61,056 at n.83.

⁸⁶ See *Kern River Gas Transmission Co.*, 88 FERC ¶ 61,261 (1999).

rate increase in this rate case. Having failed to meet that burden, the Commission may order refunds subject to the refund floor in this proceeding.

64. In Opinion No. 486-C, the Commission stated that, when a pipeline files an overall rate increase under NGA section 4, its burden of proving the justness and reasonableness of its proposed overall rate increase includes proving that all of the cost and throughput components of the rate increase in the filing are just and reasonable, even when the pipeline has not proposed to change certain of those components.⁸⁷ The Commission cited *Northern Border Pipeline Company*⁸⁸ and *Northwest Pipeline Corporation*⁸⁹ in support of this proposition. On rehearing, Kern River argues that the Commission's ability to order modifications to a component of a rate on a retrospective basis under section 4 of the NGA is limited to proposed changes integral to the overall rate, *i.e.*, specific cost components, and does not extend to changes to the rate methodology used by the filing party.⁹⁰ Accordingly, Kern River argues that the Commission's reliance on the *Northern Border* and *Northwest* cases to support its conclusion is misplaced. Kern River states that both of those cases dealt with a specific cost component – depreciation – that was determined to be an integral part of the pipeline's proposed overall rate increase.⁹¹

65. Kern River states that the Commission has implicitly recognized, however, that the “integrally related” rate concept does not justify retroactive changes in the methodology a pipeline uses to determine its proposed rates.⁹² Kern River explains that the Commission in *Trunkline* relied upon its NGA section 4 authority to order changes to the pipeline's unchanged depreciation rate, noting that cost components that are “integrally related” to the overall proposed rate increase can

⁸⁷ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 156.

⁸⁸ 89 FERC ¶ 61,272, at 61,881 (1999) (*Northern Border*).

⁸⁹ 92 FERC ¶ 61,287, at 62,012 (2000) (*Northwest*).

⁹⁰ Kern River's January 19, 2010 Request for Rehearing at 11 (citing *Northern Border*, 89 FERC, at 61,575; *Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1579 (D.C. Cir. 1993) (*Western Resources*)).

⁹¹ *Id.* 12.

⁹² *Id.* (citing *Trunkline Gas Co.*, Opinion No. 441, 90 FERC ¶ 61,017, at 61,079-081 (2000) (*Trunkline*)).

be modified by the Commission pursuant to NGA section 4. But Kern River explains that the Commission went on to reject arguments for a change in the as-filed and unchanged 125 percent load factor design of the pipeline's peak interruptible rates and 100 percent load factor design for off-peak interruptible service. Kern River states the Commission held that any such change could be imposed only under NGA section 5 and that the parties seeking to modify Trunkline's load factor failed to meet the dual burden of showing that the existing load factors were unjust and unreasonable and that their proposed load factor change would be just and reasonable.

66. Contrary to Kern River's contentions, the Commission finds that *Northern Border*, *Northwest Pipeline*, and *Trunkline* do support our actions in this case. As already discussed, Kern River's proposal to use rate design volumes equal to 95 percent of the Original System's design capacity did not continue an existing rate design methodology that could only be changed under NGA section 5. Moreover, just as continuing an unchanged item, or reducing such an item, in a cost of service is an integral part of the proposed overall rate increase, Kern River's proposal to reduce the billing determinants from an amount equal to 96 percent of design capacity (and eliminate revenue crediting) approved in its last NGA rate case Settlement represents an integral part of its proposed overall rate increase.

67. Lastly, Kern River's use of *Trunkline* for support in its argument fails. In *Trunkline*, the pipeline proposed to continue the existing design of its interruptible transportation (IT) rates. In its prior rate case, Trunkline had designed its peak IT rate as a 100 percent load equivalent to its firm rate and its off-peak IT rate as a 125 percent load factor equivalent to its firm rate; in its next rate case Trunkline proposed no change in that IT rate design. That contrasts with the situation here, where Kern River has not proposed to continue an existing rate design methodology. Moreover, the Commission explained in *Trunkline*, that "Trunkline's IT rate design is not part of Trunkline's proposed overall rate increase as are Trunkline's depreciation rates."⁹³ Regardless of what load factor is used in designing a pipeline's IT rates, the Commission designs the pipeline's overall rates to recover revenues equal to the pipeline's approved cost of service. Thus, a change in the load factor used to design IT rates may affect the relative allocation of costs between firm and interruptible service, but it would not increase the overall revenues produced by those rates. By contrast, Kern River's proposal to reduce the total billing determinants used to design its Original System rates

⁹³ *Id.*, 61,080 n.111.

increases the per unit rates for all of Kern River's services and thus does increase the overall revenue produced by those rates. Thus, Kern River's billing determinants are integral to its overall rate increase proposal, similar to an individual cost-of-service item, such as depreciation. For these reasons, the *Northern Border*, *Northwest*, and *Trunkline* cases support the Commission's action rather than bar the Commission from applying its decision retroactively as Kern River suggests. Accordingly, the Commission denies Kern River's request for rehearing on this issue.

3. Cost Allocation between 10-year and 15-year Original System Shippers

68. When Kern River filed to comply with the requirement that it design its Original System rates based on actual test period billing determinants, it failed to also use those billing determinants to allocate costs between the 10-year and 15-year Original System shippers.⁹⁴ This issue arises because Kern River's 10-year shippers have contracts for volumes equal to their share of the Original System's design capacity (100,033 Dth). However, the 15-year shippers not only have year-round contracts for their share of the Original System's capacity (624,416 Dth), but three 15-year shippers also have seasonal contracts with annualized contract entitlements of 15,154 Dth. In its filings to comply with Opinion Nos. 486 and 486-A, Kern River included the billing determinants related to the 15-year shippers' seasonal contracts when it designed the Original System rates (i.e. calculated per unit rates). However, when it allocated costs between the 10-year and 15-year shippers, it excluded the 15-year shippers' seasonal contracts.

69. In Opinion No. 486-C, the Commission held that it is unjust and unreasonable for Kern River to use different reservation billing determinants for allocating costs between the 10-year and 15-year Original System shippers and for calculating the per-unit rates for the same shippers. The Commission explained that all aspects of Kern River's Original System rate design, including the allocation of costs, should be based on the same reservation determinants,⁹⁵

⁹⁴ As discussed above, while the costs of the 2002 Expansion have been rolled into the Original System, Kern River's shippers have separate contracts for service on the Original System and the 2002 Expansion. Because the billing determinants at issue here relate only to the shippers' Original System contracts, in our discussion of this issue here, we will refer solely to the Original System and the Original System shippers.

⁹⁵ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 167.

and therefore Kern River must also use actual billing determinants when allocating costs between the 10-year and 15-year Original System shippers.⁹⁶

70. In Opinion No. 486-A, the Commission interpreted a Kern River answer to BP's contentions on this issue to state that, in its original rate filing in this case, Kern River had included the 15-year shippers' seasonal contracts in its allocation of costs between the 10-year and 15-year shippers, and the Commission stated that nothing in Opinion No. 486 had permitted Kern River to change how it allocated costs between 10-year and 15-year shippers. However, as discussed below, Kern River has clarified in its request for rehearing that it did not include the seasonal contracts in its allocation of costs in its original filing in this case.

Kern River's Request for Rehearing

71. Kern River argues the Commission's modification of Kern River's reservation determinants used for cost allocations between 10-year and 15-year Original System Shippers is not supported by substantial evidence and is arbitrary and capricious.

72. Kern River states that in comments on Kern River's March 2, 2009 compliance filing, BP challenged for the first time the reservation billing quantities Kern River used to allocate costs between the 10-year and 15-year Original System Shippers. Kern River explains that BP argued it was improper for Kern River to use different reservation quantities for cost allocation than it must use for rate design purposes. Kern River states that the Commission agreed with BP and directed Kern River to use the actual reservation billing determinants for allocating costs between the 10-year and 15-year Original System shippers, as well as for the purpose of designing per-unit rates for those shippers.⁹⁷

73. Kern River argues that the Commission's directive concerning the use of revised billing determinants for purposes of allocating costs between 10-year and 15-year Original System shippers was based on an inaccurate assumption regarding the content of Kern River's prior filings. Kern River states that the Commission misinterpreted Kern River's statement in its April 15, 2009 Reply that it used "100 percent load factor reservation billing determinants" to allocate

⁹⁶ *Id.* P 171.

⁹⁷ Kern River's January 19, 2010 Request for Rehearing at 17-18 (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at P 171).

costs between the Original System shipper groups.⁹⁸ Kern River states that the Commission clearly – but incorrectly – took Kern River’s reference to 100 percent load factor reservation determinants to indicate that Kern River had changed its approach in its compliance filings, i.e., that Kern River previously had included seasonal contract determinants in the allocation quantity, but removed them in the compliance filing.

74. Kern River clarifies that it did not change its allocation determinants and has consistently allocated costs to the 15-year Original System shippers based on their share of the full design capacity of the Original System, as represented by their year-round contract billing determinants. Kern River argues that because the Commission’s decision in Opinion No. 486-C that Kern River must modify its allocation quantities for 15-year Original System shippers was based on an erroneous premise, it is not a product of reasoned decision-making. Kern River argues that prior to BP’s protest, no participant contested Kern River’s allocation quantity for 15-year Original System shippers, or claimed that the difference between the allocation quantity and the corresponding determinants that Kern River used for rate design purposes created an unjust and unreasonable result. Kern River argues that this is important for three reasons.

75. First, Kern River states that there is no evidence in the record suggesting that Kern River’s allocation quantities, or its use of different reservation determinants for allocation and rate design purposes, results in unjust and unreasonable rates for Original System shippers. Second, Kern River argues that because the Commission’s prior orders in this case directed no change in Kern River’s allocation determinants for 15-year Original System shippers, the Commission in Opinion No. 486-C could not have found any compliance obligation with which Kern River did not comply. Kern River states that the Commission’s regulations forbid making changes in a compliance filing other than those required by the Commission in its underlying order.⁹⁹ Third, Kern River argues that the Commission relied on a factual error to reject Kern River’s position in Opinion No. 486-C.¹⁰⁰ Kern River argues the Commission should therefore grant rehearing and reinstate its prior orders’ acceptance of Kern River’s allocation quantity for 15-year Original System shippers.

⁹⁸ *Id.* 20 (citing Kern River’s April 15, 2009 Reply at 15).

⁹⁹ *Id.* at 22 (citing 18 C.F.R. § 154.203(b)).

¹⁰⁰ *Id.* (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at P 170).

76. Kern River states that in the alternative, if the Commission does not reverse its decision, the Commission may only impose the change in the allocation determinants to be effective prospectively. Kern River argues that the Commission's mandated change to Kern River's proposed billing determinants constitutes a change pursuant to NGA section 5 and, as such, may not be imposed retroactively. Kern River states that it necessarily follows that the Commission's related change to the billing determinants used for cost allocation may likewise take effect only prospectively from the date of the Commission's final order.¹⁰¹

Commission Determination

77. The Commission denies Kern River's request for rehearing on this issue. The Commission continues to find that it is unjust and unreasonable for Kern River to use different reservation billing determinants for allocating costs between the 10-year and 15-year Original System shippers and for calculating the per-unit rates for the same shippers.

78. The Commission acknowledges that it misunderstood Kern River's statement concerning the reservation billing determinants it used for 15-year Original System shippers in its initial April 30, 2004 filing in this rate case. As Kern River clarified in its request for rehearing and shown on the table below, the reservation billing determinants Kern River used for cost allocation from the April 30, 2004 rate filing onward¹⁰² have been based on 100 percent of the annual design capacity of the Original System that is subscribed under the 10-year and 15-year shipper Original System contracts, and includes no determinants associated with 15-year shippers' seasonal firm contracts.¹⁰³ The actual

¹⁰¹ *Id.* at 24 (citing *Western Resources, Inc. v. FERC*, 9 F.3d 1568 (D.C. Cir. 1993)).

¹⁰² This December 18, 2006 compliance filing was the first filing after the Commission determined that Kern River was to use actual projected units of service to design the rates. Thus the rise in billing determinants utilized for rate design from 593,195 Dth to 639,570 Dth. Opinion No. 486, 117 FERC ¶ 61,077 at P 84-86.

¹⁰³ See Kern River's January 19, 2010 Request for Rehearing at 19. In Opinion No. 486-C, the Commission noted:

Kern River states that its proposed billing determinants represent 95 percent of the annual design capacity of its Original System facilities. Kern River asserts that the greater quantity prescribed by

(continued...)

reservation billing determinants Kern River has used in each of its filings in the case are displayed in the chart below. Therefore, the Commission's original understanding of Kern River's filing that Kern River previously had included seasonal contract determinants in the allocation quantity, but removed them in the compliance filing was incorrect.

Kern River Filing	System	Allocation	Rate Design	Rate Design Units as % of Alloc. Units
(1)	(2)	(3)	(4)	(5)
4/30/04 Initial Filing	10-year Shippers	100,033	95,031	95%
	15-year Shippers	624,416	593,195	95%
12/15/04 45-Day Update Filing	10-year Shippers	100,033	95,031	95%
	15-year Shippers	624,416	593,195	95%
12/18/06 Compliance Filing	10-year Shippers	100,033	100,033	100%
	15-year Shippers	624,416	639,570	102%
3/ 2/09 Compliance Filing	10-year Shippers	100,033	100,033	100%
	15-year Shippers	624,416	639,570	102%
9/22/09 Compliance Filing	10-year Shippers	100,033	100,033	100%
	15-year Shippers	624,416	639,570	102%

the Commission equals the design capacity of the Rolled-in System, plus an amount equal to the annualized contract demand under three 15-year contracts for seasonal firm service utilizing the rolled-in facilities. Kern River's April 14, 2009 Answer at 14 (citing Ex. KR-119, Datafile.xls, General Data Tab (Protected Materials)). Opinion No. 486-C, 129 FERC ¶ 61,240 at fn.210.

79. The Commission now understands Kern River's contention that it has used the same reservation billing determinants for the 15-year shippers for allocation purposes throughout this proceeding. However, the Commission does not find this to be a basis to reverse its decision on rehearing. The key point is that in this rate case, Kern River proposed both to allocate costs between 10-year and 15-year Original Shippers and design those shippers rates based upon the design capacity of the Original System, thus excluding the 15-year shipper seasonal contracts from both rate design and cost allocation. While Kern River designed the Original System rates based on 95 percent of design capacity, but allocated costs between the two shipper groups based upon their shares of 100 percent of design capacity, the result is the same as if Kern River had allocated costs between the two shipper groups based upon their shares of 95 percent of design capacity. The same allocation percentages result from either calculation.

80. When the Commission ordered Kern River to design the Original System rates based on actual test period reservation billing determinants, Kern River included the annualized billing determinants associated with the 15-year shippers' seasonal contracts in the volumes used to calculate per unit rates, but failed to include those determinants in its allocation of costs. This results in a mismatch between the volumes used to allocate costs and the volumes used to calculate per unit rates, which the Commission did not intend in Opinion Nos. 486 and 486-A. The Commission's requirement in those orders to use actual test period reservation billing determinants to design Original System rates naturally carried with it a requirement to use the same billing determinants for allocation purposes. The term "rate design" is often used to connote the more general process of designing rates which includes cost allocation.¹⁰⁴ Moreover, absent some unique situation which Kern River has not alleged, any mismatch between the volumes used to allocate costs and calculate per unit rates would lead to unjust and unreasonable results.

81. In this case, because Kern River has excluded the 15-year shippers' seasonal contract reservation billing determinants from allocating costs between the 15-year shippers and the 10-year shippers, this results in a lower amount of costs being allocated to 15-year shippers and a correspondingly higher amount of costs allocated to 10-year shippers. Such an allocation fails to recognize the

¹⁰⁴ See *e.g. Policy Statement Providing Guidance with Respect to the Designing of Rates*, 47 FERC ¶ 61,295 at 62,052 n. 14 (1989), describing the Commission's "rate design process" as including four steps and stating that the last step, determining unit rates for each service, "is also known as rate design."

15-year shippers' increased use of the Original System through their seasonal contracts, and thus fails to 'produce revenues from each class of customers which match, as closely as practicable, the costs to serve each class or individual customer.'¹⁰⁵ Under this methodology, the 10-year shippers would bear an increased share of costs and such a misallocation is not be consistent with the Commission's determination that the costs must be designed based upon projected units of service.

82. Regardless of whether Kern River consistently used the same billing determinants throughout the course of this proceeding for purposes of cost allocation, the Commission still finds it improper for Kern River to allocate costs between the 10-year and 15-year Original System shippers using reservation billing determinants based on 100 percent of design capacity, excluding seasonal firm contracts. As we stated in Opinion No. 486-C, Kern River must use the same billing determinants for all aspects of its Original System rate design, including cost allocation.¹⁰⁶ Although the Commission has modified its rationale in response to information provided by Kern River, this determination – that the same billing determinants must be used to for all aspects of rate design and allocation on the Rolled-in System – will be effective as set forth in Opinion No. 486-C.

4. Rate Base Allocation Issues

83. BP's January 15, 2010 rehearing request asserts that Opinion No. 486-C erred by not: (1) addressing its claim that Kern River incorrectly allocated accumulated regulatory depreciation and accumulated deferred income taxes (ADIT) balances between two category of shippers; (2) requiring Kern to use the Commission preferred method of directly tracking the specific accumulated regulatory depreciation balances of each of the Rolled-In System and the 2003 Expansion; (3) requiring Kern River to use a direct tracking method to establish the accumulated regulatory depreciation balances, and; (4) requiring Kern River to use a direct tracker for the specific ADIT balances for the 10 and 15 year shippers. BP also asserts that the Commission also incorrectly stated that BP had not alleged specific errors in Kern River's compliance filings that caused a rate

¹⁰⁵ *Alabama Electric Co-op. Inc. v. FERC*, 684 F2d 24, 27 (D.C. Cir. 1982).

¹⁰⁶ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 169-171. As can be seen in the above chart, in its April 30 and December 15, 2004 filings, Kern River utilized billing determinants for rate design based upon 95 percent of its allocation billing determinants. This difference in allocation and rate design determinants did not lead to a mathematical difference in the rates for the shippers.

disparity, a point that is mooted by the Commission's consideration of BP's request for rehearing at this time.¹⁰⁷

84. While BP attached to its January 10, 2010 rehearing request of Opinion No. 486-C certain portions of the record,¹⁰⁸ to fully address BP's assertions requires revisiting the comments and reply comments of both BP and Kern River filed regarding the March 2, 2009 compliance filing Kern River made in response to Opinion No. 486-C. Such a review involves not only the technical assertions BP advanced in its comments on the March 2, 2009 compliance filing, but the procedural framework in which those comments occurred. This review is required because Kern River asserted in its reply comments on the March 2, 2009 compliance filing that BP raised the three points at issue here for the first time in the compliance phase of Opinion No. 486-C, i.e. early 2009, and that as such the arguments were untimely.¹⁰⁹ For this reason the Commission will summarize the specific language used in BP's comments on the March 2, 2009 compliance filing and compare that to the language used in its earlier pleadings, including its briefs to the ALJ during the hearing phase and its briefs on exception and opposing exceptions thereafter.

85. With the exclusion of footnotes, the following quotes BP's introduction of the rate base allocation issues as stated in its comments on Kern River's March 2, 2009 compliance filing, and as later reiterated in its rehearing request.

Kern River does not charge a single general transportation rate; it charges several different facility specific rates, each of which must be both just and reasonable, and based upon an accurate attribution of cost to the relevant facilities. The direct tracking of costs to specific facilities, to establish the beginning accumulated depreciation and accumulated deferred income tax ("ADIT")

¹⁰⁷ Request of BP Energy Company for Rehearing of Opinion No. 486-C, as summarized at pages 2-5.

¹⁰⁸ BP also appears to have included a new display or series of calculations in Exhibit B attached to its rehearing request. This is a violation of Commission protocols which prohibit the filing of new material in a rehearing request.

¹⁰⁹ *See* Reply Comments of Kern River Gas Transmission Company In Support of March 2 Compliance Filing at 23 (Kern River Reply Comments).

balances, should be the basis for separately stated rates for each set of facilities. . . .

While Kern River's approach is not unduly complex, it results in an incorrect calculation of beginning accumulated depreciation and ADIT balances. If the beginning accumulated depreciation and ADIT balances are incorrect, the resulting firm transportation rates will also be incorrect and thus will be unjust and unreasonable, throughout the balance of each affected levelization period. Accordingly, the only correct method is directly tracking cost and therefore such an approach is required in this case.¹¹⁰

BP expanded this argument in the balance of its comments on the compliance filing and attached an affidavit by Elizabeth H. Crowe containing supporting testimony to the same effect and an alternative calculation of the rate base items at the time that the rates at issue would be effective.¹¹¹

86. Kern River first asserted that BP was raising its concerns regarding the allocation of accumulated regulatory depreciation and ADIT for the first time in the context of a compliance filing. It argued that this was the equivalent of an improper rehearing request and that the arguments should be rejected,¹¹² and then stated:

Contrary to BP's contention, balances of accumulated depreciation and ADIT are tracked separately on Kern River's books and Kern River directly assigns those balances to the rolled-in and 2003 Expansion facilities. Kern River has documented these direct assignments in the record.¹¹³

¹¹⁰ See Comments and Protest of BP to Kern River's March 2, 2009 Compliance Filing at 21-22 (BP Comments) and Appendix B thereto, Affidavit of Elizabeth H. Crowe at 3 and Exhibit 3.

¹¹¹ *Id.* Appendix B, Affidavit of Elizabeth H. Crowe at 3 and Exhibit 3.

¹¹² Kern River Reply Comments at 23.

¹¹³ *Id.*

To support its conclusions regarding the allocation of accumulated depreciation and ADIT, Kern River included in its reply a detailed analysis of the two most relevant exhibits, Exhibit Nos. KR-100 and KR-94,¹¹⁴ while maintaining its position that BP's comments were untimely.¹¹⁵ In its reply comments BP included an additional affidavit by Ms. Crowe that reiterated her earlier analysis.¹¹⁶

87. Given Kern River's argument that BP's comments and additional factual materials are untimely, the Commission first reiterates the fundamental principal that new arguments and evidence may not be introduced in the compliance phase of a proceeding when the opportunity existed to introduce the issue during the hearing phase of the proceeding. The only issue in the compliance phase is whether the jurisdictional entity at issue has complied with the directions of the relevant Commission order.¹¹⁷ Thus, to determine whether BP raised the four rate base allocations matters at issue here, the Commission reviewed BP's pleadings that preceded Kern River's March 2, 2009 compliance filing. These include BP's Initial and Reply Briefs to the ALJ at hearing, the most relevant BP exhibits cited in those briefs (Exhibit Nos. BP-42 and BP-52), and BP's Brief on Exceptions and Brief Opposing Exceptions in response to the ID.

88. On review, it is clear that the two controlling exhibits cited by Kern River (Exhibit Nos. KR-94 and KR-100) are the correct source for the numbers at issue in the compliance filing, and BP itself specifically refers to Exhibit No. KR-100 in

¹¹⁴ *Id.* at 23-24, 25.

¹¹⁵ *Id.* 25, 26.

¹¹⁶ Reply Comments of BP Energy Company Regarding Kern River Gas Transmission Company's March 2, 2009 Compliance Filing, Appendix B, Affidavit of Elizabeth H. Crowe at 2-3.

¹¹⁷ See *El Paso Natural Gas Co.*, 115 FERC ¶ 61,280, at P 5 (2006); *City of Cleveland, Ohio v. FERC*, 773 F.2d 1368, 1374 (D.C. Cir. 1985); *Sierra Pacific Power Co.*, 80 FERC ¶ 61,376, at 62,271 (1997) ("a compliance filing is not an appropriate mechanism to challenge Commission directives. If [a party] is dissatisfied with any aspect of a Commission order, or is uncertain as to the extent of the directives the Commission is ordering, it should seek rehearing or clarification of that order, as appropriate. The sole purpose of a compliance filing is to make the revisions directed by the Commission."); *Delmarva Power & Light Co.*, 63 FERC ¶ 61,321, at 63,160 (1993).

its comments on the March 2, 2009 compliance filing.¹¹⁸ However, there is no reference to either exhibit in any of the six previously listed documents that BP filed preceding the compliance phase. This is true even though those two exhibits supported Kern River's initial filing and were introduced into the record on October 25, 2005.¹¹⁹ BP did assert in its hearing testimony and in the cited briefs that the Kern River should adjust its ADIT balances to reflect the fact that it should not have an income tax allowance.¹²⁰ BP also argued extensively that the difference in the amortization periods between 10 and 15 year shippers resulted in a discriminatory accumulation of regulatory depreciation. BP did use this argument as a foundation for its conclusion that Kern River should be required to use traditional cost of service rates and the different depreciation accounts for the 10 and 15 year shippers rolled into one another.¹²¹ But during the hearing phase BP never questioned the method for establishing the initial balances for accumulated regulatory depreciation and ADIT. None of the language regarding the method for establishing the initial balances of accumulated regulatory depreciation or ADIT contained BP's comments on Kern River's March 2, 2009 compliance filing is found in BP's testimony at hearing, in briefs it submitted during the hearing phase or in its briefs on exceptions to the ID.

89. Thus, Kern River correctly asserts that BP failed to challenge the method for establishing the opening accumulated balances for regulatory depreciation and ADIT even though the Exhibit Nos. KR-94 and KR-100 were available to it since the beginning of the hearing. The Commission therefore concludes that Kern River is correct that BP's arguments concerning the method for establishing the accumulated regulatory depreciation and ADIT balances were untimely. Moreover, on August 16, 2010, BP filed a Motion of BP Energy Company for Official Notice. BP asserts therein that the rate base allocation matters at issue here arose in an earlier docket, Docket No. RP00-298-001, and that on July 13, 2000, Kern River filed reply comments that contradict the position Kern

¹¹⁸ BP Comments at 23-24 and n. 69

¹¹⁹ See Exhibit Nos. BP-42 and BP-52, Initial Brief of BP Energy Company, Reply Brief of BP Energy Company, Brief on Exceptions of BP Energy Company, and Brief Opposing Exceptions of BP Energy Company, *passim*.

¹²⁰ *E.g.* BP Initial Brief at 24-25; BP Brief on Exceptions at 40-41.

¹²¹ *E.g.* BP Initial Brief at 11-14, 43-44; BP Reply Brief at 13; BP Brief on Exceptions at 48-52.

River took in its March 2, 2010 compliance filing regarding its methodology for determining accumulated depreciation and ADIT balances.¹²² The Commission denies BP's August 16 motion in light of its prior conclusion that BP's arguments in that regard are untimely. But the motion in fact proves too much; a more timely search by BP of the prior proceeding would have called the matter of the method for allocating accumulated regulatory depreciation and ADIT balances to its attention. Finally, the August 16, 2010 Motion and the extensive additional materials BP filed during this compliance phase of the instant rate proceeding are emblematic of the repetitive, and often untimely, pleadings that BP has filed in this particularly complicated and protracted proceeding and the burden such filings have placed on the Commission. Rehearing of BP's arguments discussed here is denied.

B. Compliance Filing

1. January 29, 2010 Compliance Filing

90. On January 29, 2010 Kern River submitted a filing in Docket No. RP04-274-021 to comply with Opinion No. 486-C with regard to its Period One rates.

The compliance filing includes revised Period One tariff sheets¹²³ and corresponding rate derivations for all of the affected rates.

91. Kern River states that to reflect the Commission's rulings in Opinion No. 486-C, it has included seasonal billing determinants in the allocation of cost of service components such as general plant, operating revenue credits, and market-oriented revenues between 10- and 15-year Rolled-in shippers and has utilized the same reservation quantities for rate design, effective as of November 1, 2004. Kern River has also replaced the \$0.06 commodity rate shown in previous compliance filings for the Locked-in Period with a \$0.0580 commodity rate for Rolled-in shippers and a \$0.0573 commodity rate for expansion shippers to reflect the respective commodity rates that were in effect prior to November 1, 2004. Kern River requests that the tariff sheets be made effective as of the dates indicated, subject to any further orders of the Commission in this proceeding.

¹²² See Motion of BP Energy Company for Official Notice, at 1, 3.

¹²³ The revised Period One tariff sheets are listed in the Appendix to this order.

92. On September 28, 2010 Kern River filed a request for clarification pertaining to the Period One rates included in its January 29, 2010 compliance filing.¹²⁴ That request addressed certain compressor costs that Kern River had included as a regulatory asset in its Period One compliance filing. On September 30, 2010, Kern River filed revised tariff sheets in Docket No. RP10-1406-000 to establish and implement a limited term periodic rate adjustment and surcharge designed to recover the same compressor costs addressed by its request for clarification within the remaining time frames of its Period One rates. The Commission accepted and suspended this proposed surcharge subject to refund on October 29, 2010.¹²⁵ On November 4, 2010, Kern River filed a revised Period One compliance filing in Docket No. RP11-1499-000 designed to recover the same compressor costs addressed by its request for clarification and the proposed surcharge. In this order, we only address Kern River's January 29, 2010 compliance filing. The three recent filings will be addressed in a subsequent order, and our acceptance in this order of Kern River's January 29, 2010 filing is subject to the outcome of our consideration of the three subsequent filings.

2. Notice and Protests

93. Notice of Kern River's January 29, 2010 compliance filing in Docket No. RP04-274-021 was issued on February 2, 2010. Comments were due as provided in section 154.210 of the Commission's regulations, 18 C.F.R. § 154.210 (2010). BP filed a protest. Nevada Power Company (NVE) filed comments. NVE respectfully requests that the Commission expedite its review of the Period One rates and place the compliance rates into effect as soon as possible.

94. BP argues that Kern River continues to incorrectly allocate accumulated regulatory depreciation between the 10-year and 15-year shippers, reducing the beginning rate base amount of accumulated regulatory depreciation attributed to the 10-year shippers below even the levels contained in prior compliance filings in this proceeding. BP states that in Kern River's latest filing, Kern River has revised accumulated regulatory depreciation balances from the balances previously set forth to the detriment of the 10-year shippers. BP states that the Commission has held that Kern River's "levelized rate structure, *including its schedule of plant recoveries*, was...a key aspect of the allocation of risks" between

¹²⁴ See *Kern River Gas Transmission Company*, 133 FERC ¶ 61,105 (2010) at P 3.

¹²⁵ *Id.*

Kern River stakeholders.¹²⁶ Thus, BP asserts the Commission has previously recognized that the amortization schedules are an essential component of the allocation of risks between various Kern River stakeholders.

95. BP states that because different classes of shippers have paid different amounts of depreciation under Kern River's incremental, term-specific rate structure, Kern River's incorrect allocation of accumulated regulatory depreciation balances effectively gives one group of shippers (i.e., the 15-year shippers) the benefit of payments made by another group of shippers (i.e., the 10-year shippers). BP contends such a result contravenes the entire basis of Kern River's incremental and term-specific rate structure, as recognized by the Commission.

96. Moreover, BP asserts that if the beginning accumulated regulatory depreciation balance is incorrect for a particular class of shippers, the resulting firm transportation rates will also be incorrect, and thus unjust and unreasonable, throughout the balance of each affected levelization period, and thereafter. BP's initial calculations reveal that Kern River's incorrect allocation of more than \$1 million of accumulated regulatory depreciation¹²⁷ materially increases the 10-year Rolled-In System shippers' Period One rate vis-à-vis the rate resulting under a direct assignment of the accumulated regulatory depreciation to each set of shippers. BP argues such a result is inappropriate.

97. BP states that the accumulated regulatory depreciation that has *already been paid* by each group of shippers (based on the depreciation schedules reflected in Kern River's levelized rates) cannot now be reallocated, as recognized by the Commission's holding that Kern River's schedule of plant recoveries is an essential component of the allocation of risks between Kern River stakeholders. BP states that the rates paid by each set of shippers must reflect the amounts of accumulated regulatory depreciation they have *actually paid*. BP argues any other approach results in an impermissible subsidy of one set of shippers by another set of shippers.

98. BP states that to ensure that Kern River's rates are just and reasonable, Kern River should use the best, most accurate and Commission-preferred method of establishing accumulated regulatory depreciation balances, i.e., directly tracking

¹²⁶ BP's February 12, 2010 Protest at 2 (citing *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 38 (2006) (emphasis added)).

¹²⁷ *Id.* at 3 (citing Work papers Supporting Kern River's Period One Compliance Filing at 7).

the balances by each specific set of facilities and contract class.¹²⁸ BP states that Kern River already has the data necessary to directly assign accumulated regulatory depreciation between the 10-year and 15-year shippers. BP explains that, for example, Kern River's 45-day update filing, Exhibit No. KR-94, tracks the accumulated regulatory depreciation on a year-by-year, facility-by-facility, and shipper class-by-shipper class basis. Thus, BP argues the Commission should require Kern River to promptly submit a revised compliance filing for Period One rates that directly and separately assigns accumulated regulatory depreciation to (1) 10-year shippers and (2) 15-year shippers.

99. In response Kern River first asserts that BP's comments were untimely because Opinion No. 486 directed no changes in its treatment of the rate base elements as they are allocated between groups of facilities or shippers. It argued that BP in fact had filed an improper rehearing request and that the Commission should not consider BP's arguments filed against its compliance filing. Kern River then filed a reply stating that contrary to BP's contention, balances of accumulated depreciation and ADIT are tracked separately on Kern River's books and Kern River directly assigns those balances to the Original rolled-in and 2003 Expansion facilities. Kern River states it has documented these direct assignments between facilities in the record and expanded its reply with reference to the two most relevant parts of the record, Exhibit Nos. KR-100 and KR-94.¹²⁹ However, it explained that it did not and does not directly assign accumulated depreciation between different shipper groups, specifically between the 10 and 15-year shippers. This is done through an allocation that is based on each shipper group's accumulated regulatory DD&A balance at the end of the test period. Kern River states that this allocation method is unchallenged on the record and the BP did not raise it until the compliance phase. It reiterates this position in reply to BP's concerns about the allocation of ADIT between the 10 and 15 year shippers.¹³⁰ Kern River concludes that its analysis of the points raised by BP is unchallenged on the record and that BP's analysis is both untimely and incorrect.¹³¹

¹²⁸ *Id.* (citing *Transcontinental Gas Pipe Line Corp.*, 106 FERC ¶ 61,299, at P 190-192 (2004), *order on reh'g*, 112 FERC ¶ 61,170, at P 148-149. *See also Florida Gas Transmission Co., LLC*, 118 FERC ¶ 61,264 (2007)).

¹²⁹ Kern River Reply Comments at 23-24.

¹³⁰ *Id.* 25-26

¹³¹ *Id.* 26.

3. Commission Determination

100. The Commission accepts the tariff sheets included in Kern River's Period One compliance filing, effective on the dates listed in the Appendix to this order. That filing has properly implemented the requirements of Opinion No. 486-C, including the one change in Kern River's prospective Period One rates which Opinion No. 486-C required in Kern River's prior compliance filing conditionally accepted by that order.

101. BP is the only party filing any protest to Kern River's Period One compliance filing. The Commission addressed earlier in this order BP's assertions regarding accumulated regulatory depreciation and ADIT in the Commission's discussion of BP's January 10, 2010 rehearing request of Opinion No. 486-C. The Commission concluded that during the hearing phase BP never questioned the method for establishing the initial balances for accumulated regulatory depreciation and ADIT used in Kern River's April 30, 2004 rate filing. After an analysis of all the relevant pleadings, the Commission stated that none of the language regarding the method for establishing the initial balances of accumulated regulatory depreciation or ADIT contained in BP's March 2009 comments or April 2009 reply comments on Kern River's March 2, 2009 compliance filing is found in its testimony or in the briefs BP submitted during the hearing phase or in its briefs on exceptions to the ID. Thus, as Kern River asserts, BP failed to challenge the calculations for establishing the opening accumulated balances for regulatory depreciation and ADIT even though the Exhibit Nos. KR-94 and KR-100 were available to it since the beginning of the hearing. The Commission therefore concludes that Kern River is correct that the BP's arguments concerning the method for establishing the accumulated depreciation and ADIT balances were untimely. As with BP's 2009 rehearing request, those arguments are rejected.

III. Period Two Rates

102. As previously described, Kern River proposed in this rate case to continue to design its rates based on the levelized rate design methodology approved in its original optional expedited certificate proceeding, as modified in subsequent proceedings. While the rates approved in that certificate proceeding included separate, levelized rates for three periods, Kern River's tariff only included rates for Period One, the term of its firm shippers' initial contracts, and Kern River did not propose in this rate case to add Period Two or Three rates to its tariff. At the original hearing in this case, BP and Trial Staff contended that Kern River's proposal to continue its levelized rate design was unjust and unreasonable. BP contended that Kern River's Period One Rates improperly overrecover its costs, because they are designed to recover 70 percent of Kern River's invested capital, an amount approximately equal to the portion of its invested capital funded

through debt. This fact allows Kern River to recover more invested capital during Period One than it would under ordinary straight-line depreciation for the depreciable life of its system.

103. In Opinion No. 486, the Commission approved Kern River's proposed continuation of its levelized Period One rates on the ground that the design of Kern River's Period One rates was part of the original risk sharing agreement underlying Kern River's optional expedited certificate. The Commission explained that Kern River's accelerated recovery of its depreciation expense creates a regulatory liability which must be returned to its shippers during Period Two, the period from the expiration of Kern River's initial contracts to the end of Kern River's depreciable life. As a result, Kern River's Period Two rates will be lower than its Period One Rates, and the overrecovery during Period One will be returned to shippers during Period Two. In order to assure that the shippers will obtain the benefit of the lower Period Two rates if they continue service beyond the terms of their existing contracts,¹³² Opinion No. 486 ordered Kern River to include Period Two Rates in its tariff.

104. In Opinion No. 486-A, the Commission, in response to Kern River's claim that the Commission exceeded its authority by requiring Kern River to file its Period Two rates, the Commission explained:

In Opinion No. 486, the Commission found that Kern River's proposal to continue its levelized methodology did not result in just and reasonable rates unless the pipeline included tariff sheets reflecting the Period Two step down rates referred to in its proposal, in addition to its proposed Period One rates. As previously discussed, as of the end of Period One, Kern River will have an excess recovery of its depreciation expense. *Accordingly, we can only find the Period One rates to be just and reasonable, if Kern River's tariff also provides for the return of that excess recovery in its Period Two rates.* The Commission is well within its authority to take such action pursuant to section 5 of the NGA, even though Kern

¹³² Opinion No. 486, 117 FERC ¶ 61,077 at P 37.

River filed its proposal pursuant to section 4 of the NGA.¹³³
(Emphasis added).

105. In Opinion No. 486-B the Commission reaffirmed this action, and again ordered Kern River to file levelized Period Two Rates.¹³⁴ In its March 2, 2009, compliance filing, Kern River proposed to use a traditional rate design for its Period Two Rates, rather than continue using the leveled rate design underlying its Period One Rates. In Opinion No. 486-C the Commission found that levelized rates for Period Two were part of the original risk sharing agreement. Specifically, it determined that both the January 1990 Original Certificate Order and the January 1992 Amended Original Certificate Order contemplated the use of levelized rates for Period Two. In addition, the Commission found that the Extended Term Settlement and the orders certificating the 2002 and 2003 Expansions carried forward the original risk sharing agreement, with the exception that shippers were offered the option of 10 or 15-year contracts for Period One.¹³⁵

106. However, the Commission also established a hearing to determine how levelized Period Two rates should be calculated and what conditions the shipper must satisfy in order to be eligible for the levelized Period Two rates.¹³⁶ The Commission found that these issues included the issue of whether, and how, the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two rate levelization period. The Commission stated that there appeared to be a number of options for resolving that issue, including, but not limited to: (1) requiring shippers to enter into contracts for the entire length of Period Two, if they desire levelized rates for Period Two, (2) offering the shippers one or more options permitting them to enter into contracts of some specified minimum duration but shorter than Kern River's remaining depreciable life, while nevertheless levelizing Kern River's Period Two rates over the entire remaining depreciable life, (3) offering optional contract lengths that are shorter than Kern River's remaining depreciable life as in the previous option, but

¹³³ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 61 (*citing Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1577-79 (D.C. Cir. 1993) (finding that under the NGA, an action may originate as an NGA section 4 proceeding only to be transformed later into an NGA section 5 proceeding)).

¹³⁴ Opinion No. 486-B, 126 FERC ¶ 61,034 at P 180.

¹³⁵ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 253.

¹³⁶ *Id.* P 247.

requiring the rates in those contracts to reflect a Period Two cost of service levelized over the term of the contracts, rather than Kern River's remaining depreciable life, and (4) not requiring any minimum contract duration.¹³⁷ The Commission found that the record was inadequate to resolve these issues and that the participants in this proceeding had not had an opportunity to present evidence relevant to resolving the Period Two contract duration issue or other issues concerning what conditions shippers must satisfy in order to be eligible for the levelized Period Two rates or how such levelized rates should be calculated.¹³⁸

107. All of Kern River's firm shippers are still paying Period One Rates.¹³⁹ However, the initial contracts of the 10-year shippers for service on the Original system expire on October 31, 2011. Therefore, Period Two for those shippers commences on November 1, 2011.

A. Requests for Rehearing

108. On rehearing, Kern River raises a variety of issues related to the Period Two rates. Kern River requests that the Commission clarify that it established the hearing on Period Two rates under NGA section 5. On the merits, Kern River contends that the Commission erred in rejecting Kern River's proposal to base its Period Two Rates on a traditionally calculated cost of service, and requiring Kern River instead to file levelized Period Two rates. Kern River argues that the Commission failed to support its holding that the original risk sharing agreement underlying the certificate for its original system required levelized rates in Period

¹³⁷ *Id.*

¹³⁸ *Id.* P 261- 263. The Commission also emphasized that it did not intend that any issues already litigated and decided in this proceeding be re-litigated.

¹³⁹ The expiration dates of the various contracts are as follows:

Original system – 10-year contracts (expires 2011);
Original system – 15-year contracts (expires 2016);
2002 Expansion – 10-year contracts (expires 2012);
2002 Expansion – 15-year contracts (expires 2017);
2003 Expansion – 10-year contracts (expires 2013);
2003 Expansion – 15-year contracts (expires 2018);
and Big Horn Lateral contracts (expires 2017). *See*
Ex. KR-45 at 4, line 7-8.

Two and that the absence of any contracts for Kern River's service in Period Two makes levelized rates infeasible in Period Two.

1. Whether the Commission Must Proceed under Section 5

109. As Kern River points out, Ordering Paragraph (F) of Opinion No. 486-C establishing the hearing concerning Period Two Rates included a reference to section 4, as well sections 5, 8, and 15 of the NGA.¹⁴⁰ The Commission grants Kern River's request to clarify that the hearing for the Period Two rates was established pursuant to sections 5, 8, and 15 of the NGA, and not section 4. In Opinion Nos. 486, 486-A, and 486-C, the Commission expressly recognized that it was acting under NGA section 5 in requiring Kern River to include Period Two Rates in its tariff because Kern River's tariff does not include such rates. Nor did Kern River propose such rates in its current section 4 rate case.¹⁴¹

¹⁴⁰ Ordering Paragraph (F) of Opinion No. 486-C states:

Pursuant to the authority contained in and subject to the jurisdiction conferred upon the Federal Energy Regulatory Commission by section 402(a) of the Department of Energy Organization Act and by the Natural Gas Act, particularly sections 4, 5, 8 and 15 thereof, and pursuant to the Commission's Rules of Practice and Procedure and the regulations under the Natural Gas Act (18 C.F.R., Chapter I), a public hearing shall be held concerning the justness and reasonableness of the Kern River's Period Two rates. However, the hearing will be held in abeyance to provide time for settlement judge procedures, as discussed in Ordering Paragraphs (G) and (H) below.

¹⁴¹ The Commission cited *Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1577-79 (D.C. Cir. 1993) (finding that under the NGA, an action may originate as a § 4 proceeding only to be transformed later into an NGA § 5 proceeding). This case also holds that the Commission should bear the burden under § 5 whenever it moves beyond rejection of a proposed rate to the task of redesigning it. *Id.* (citing *Tennessee Gas Pipeline Co. v. FERC*, 860 F.2d 446, 454 (D.C. Cir. 1988) (quoting with approval an ALJ's statement to this effect); *Sea Robin Pipeline Co. v. FERC*, 254 U.S. App. D.C. 137, 795 F.2d 182, 187 (D.C. Cir. 1986) (reasoning that Commission moves out of § 4 range when approved rate methodology deviates from that proposed by the pipeline)).

110. Pursuant to NGA section 5, the Commission must satisfy a two-prong burden of proof when it seeks to change a pipeline's existing rates or practices. The Commission must demonstrate: (1) that the existing rate or practice is unjust and unreasonable; and (2) that the proposed alternate rate or practice is just and reasonable.¹⁴² In Opinion Nos. 486 and 486-A, the Commission held that Kern River's failure to include in its tariff Period Two Rates that will take effect when its current firm shippers' contracts expire is unjust and unreasonable. The Commission found that the levelized Period One rates set forth by Kern River were not just and reasonable unless the shippers that paid the Period One rates could obtain the benefit of their bargain by virtue of the Period Two rates. As explained in those orders, because the Period One Rates allow Kern River to overrecover its depreciation expense during Period One, its tariff must include the lower Period Two Rates in order to assure the timely return of that excess recovery during Period Two. Thus, the Commission has satisfied the first prong of its section 5 burden in Opinion Nos. 486 and 486-A. The purpose of the hearing established by Opinion No. 486-C is to help develop a record for the purpose of establishing just and reasonable Period Two Rates consistent with the second prong of the Commission's section 5 burden.

2. Whether Period Two Rates must be Levelized

111. For the reasons discussed below, the Commission reaffirms its holding that, in order for Kern River's Period Two Rates to be just and reasonable, they must be levelized. In Opinion No. 486-C, the Commission focused on the issue of whether the risk sharing agreement underlying the optional expedited certificate for Kern River's Original System required that Kern River's Period Two Rates be levelized. The Commission explained that a central issue in approving an optional expedited certificate was whether the pipeline's rates reflected an appropriate allocation of the risks of the project as between the pipeline, its customers, and other interested parties, and therefore the Commission will not lightly change the allocation of risk inherent in such a certificate absent some overarching policy reason.¹⁴³ Based upon its review of the January 1990 Original Certificate Order, the January 1992 Amended Original Certificate Order, and the orders on rehearing of those two

¹⁴² See, e.g., *ANR Pipeline Co. v. FERC*, 771 F.2d 507, 513-14 (D.C. Cir. 1985); *Public Service Commission of the State of New York v. FERC*, 642 F.2d 1335, 1350 n.27 (D.C. Cir. 1980).

¹⁴³ Opinion No. 486, 117 FERC ¶ 61,077 at P 38; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 19; Opinion No. 486-C, 129 FERC ¶ 61,240 at P 248.

orders, the Commission concluded that those orders contemplated the use of levelized rates for Period Two.

112. On rehearing, Kern River attacks the Commission's holding that the Period Two rates must be levelized on three primary grounds: (a) the Commission improperly focused solely on the certificate orders, without considering the fact that the contracts between Kern River and its shippers contained no provisions requiring levelized rates for Period Two, (b) in any event, the Commission incorrectly interpreted the orders in the certificate proceeding for its Original System as providing for levelized rates during Period Two, and (c) the Commission provided no other legally sustainable reason for requiring the Period Two Rates to be levelized.

113. The Commission denies rehearing, for the reasons discussed below. In the first section below, the Commission finds that the Commission's orders granting Kern River's optional expedited certificate established rate design principles intended to apply for the life of its project, regardless of the fact that the shipper's initial contracts expired at the end of Period One. While the certificate orders did not impose an absolute prohibition on Kern River or others seeking a change in rate design in subsequent section 4 or 5 proceedings, those orders created a strong presumption, applicable in any subsequent section 4 or 5 proceeding, that the rate design underlying the Commission's approval of Kern River's optional expedited certificate would continue for the life of the project.

114. In the second section below, the Commission finds that the certificate orders clearly intended that Kern River's Period Two rates be levelized.

115. In the third section, the Commission finds that the rate design principles approved in the optional expedited certificated proceeding, with levelized rates for both Periods One and Two, work together as an integrated whole to produce just and reasonable rates for the life of a project. Kern River's proposal in this proceeding to depart from those principles and use a different rate design for Period Two than for Period One would produce an unjust and unreasonable result.

a. Rate Design Principles Underlying Optional Expedited Certificate

116. In Opinion No. 486-C, the Commission stated that the issue whether Kern River's Period Two rates must be levelized turns on whether levelized rates for Period Two were part of the risk sharing agreement underlying the certificate for the Original System and carried forward in the Extended Term Settlement and the certificates for the 2002 and 2003 Expansions. The Commission then analyzed both the January 1990 Original Certificate Order and the January 1992 Amended Original Certificate Order issued in Kern River's optional expedited certificate

proceeding, and the Commission found that those orders contemplated the use of levelized rates for Period Two.¹⁴⁴

Kern River's Rehearing Request

117. Kern River argues that the Commission's examination of the parties' risk-sharing intentions improperly focused exclusively on the Commission's own orders, without any examination of the service agreements, financing documents, or other evidence directly germane to any "negotiated bargain" the involved parties may have struck. Kern River argues that nothing in the original shipper contracts, the contract extensions, or other record evidence reveals any agreement by the parties to any particular methodology governing Period Two rates. Further, Kern River asserts that under contract law, unless intent is unambiguously stated in writing, inquiries into parties' intentions present uniquely factual issues.

118. Kern River also argues that Opinion No. 486-C does not assert that the Commission conditioned Kern River's certificate to require the company to offer levelized rates in Period Two, and Kern River further asserts that in the certificate proceeding the parties entered into no such bargain concerning the Period Two rates. Moreover, Kern River argues that the Commission's ruling is undermined by its finding that the "record contains no indication that the parties fully considered or agreed upon the terms and conditions under which Kern River would offer such levelized rates" in Period Two.¹⁴⁵ Kern River argues that the Commission, therefore, claims the existence of a bargain that Period Two rates would be levelized but simultaneously acknowledges the absence of proof that the parties even discussed – much less agreed on – the essential terms and conditions of that bargain. Kern River further argues that, at a minimum, the Commission should have included in the evidentiary hearing it established regarding Period Two rates the factual question of whether there are any agreements between Kern River and its shippers with respect to how Period Two rates are to be determined.

119. Kern River also argues that interpreting the optional expedited certificate orders as requiring Kern River to use levelized rates in Period Two unlawfully restricts Kern River's right to propose changes to its rates under section 4 of the NGA. Kern River argues that the Commission's rate-related authority under section 7 is limited to setting initial rates, and does not authorize adjustments to

¹⁴⁴ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 253.

¹⁴⁵ Kern River Rehearing Request at 29 (*citing* Opinion No. 486-C, 129 FERC ¶ 61,240 at P 257).

rates once a pipeline is in service. Kern River asserts that the Commission, therefore, cannot rely on its section 7 certificate authority to dictate that Kern River's Period Two rates must be levelized.

Commission Determination

120. In considering how Kern River's Period Two rates should be designed, the Commission has properly focused on the rate design principles approved in Kern River's optional expedited certificate proceeding, as opposed to the provisions of individual shippers' contracts for service during Period One. The Commission recognizes that, during Kern River's certificate proceeding and thereafter, Kern River and its shippers only entered into contracts for service during Period One. Therefore, Kern River has no bilateral contracts with its shippers requiring it to offer levelized rates during Period Two. However, for the reasons discussed below, the Commission finds that the orders approving Kern River's optional certificate created a strong presumption, applicable in any subsequent section 4 or 5 proceeding, that the rate design underlying the Commission's approval of Kern River's optional expedited certificate would continue for the life of the project. While the certificate orders did not impose an absolute prohibition on Kern River or others seeking a change in rate design in subsequent section 4 or 5 proceedings, the circumstances of Kern River's certification are a significant factor that must be taken into account in determining whether any proposed change is just and reasonable.

121. The Commission's optional expedited certificate regulations, adopted by Order No. 436, provided pipelines a streamlined procedure for obtaining a certificate for a project, if the pipeline agreed to assume the full economic risk of the project. NGA section 7(c) requires that the Commission find that a project is required by the "public convenience and necessity" before granting a certificate. Under the Commission's traditional certificate procedures, an applicant had to show, among other things, that there was market demand for the proposed project, that the proposed facilities were properly sized to serve that market, that the anticipated construction costs were reasonable, and that estimated revenues would produce earnings sufficient to retire any debt and provide a return to investors.¹⁴⁶

¹⁴⁶ *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 436, FERC Stats. & Regs. ¶ 30,665 at 31,582-583 (1985) (Order No. 436).

Determining whether the applicant had satisfied those requirements often required extended and cumbersome hearings.¹⁴⁷

122. The optional expedited certificate procedures sought to minimize the need for such hearings by granting an applicant for an optional expedited certificate a rebuttable presumption that its project met the statutory prerequisites for granting a certificate under NGA section 7.¹⁴⁸ In order to obtain that presumption, the applicant for the certificate had to be willing to assume the full economic risk of the project.¹⁴⁹ As the Commission explained in Order No. 436,¹⁵⁰

The applicant's willingness to assume . . . all risks pertaining to a project is critical to our presumption that such projects are in the public interest, and may therefore be processed with expedition. Any dilution of this assumption of the risk would gravely undermine the basis for this presumption.

Therefore, a central issue the Commission had to decide before approving an application for an optional expedited certificate was whether the pipeline's proposed rates reflected an appropriate allocation of the risks of the project as between the pipeline, its customers, and other interested parties.¹⁵¹

123. The Commission carefully considered the issue of how a pipeline may satisfy the assumption of risk requirement in the related optional expedited certificate proceedings of WyCal, Kern River, and Mojave. All three pipelines competed to construct pipelines to transport natural gas from Wyoming to Kern County California to serve the California Enhanced Oil Recovery (EOR)

¹⁴⁷ *AGD I*, 824 F.2d 981, 1030 (D.C. Cir. 1987), affirming this aspect of Order No. 436.

¹⁴⁸ 18 C.F.R. § 157.104(c).

¹⁴⁹ 18 C.F.R. § 157.103(d).

¹⁵⁰ Order No. 436, FERC Stats. & Regs. ¶ 30,665 at 31,577. *See also AGD I*, 824 F.2d at 1037.

¹⁵¹ *Mojave Pipeline Co.*, 81 FERC ¶ 61,150 at 61,682-683 (footnote omitted).

market.¹⁵² In 1987, WyCal filed an application for an optional expedited certificate. WyCal initially proposed rates based on a levelized cost of service to be recovered over a proposed 15-year depreciable life. WyCal also proposed a 70 percent/30 percent debt/equity ratio and a maximum reservation charge including all fixed costs other than return on equity and associated taxes. Kern River and Mojave, who had previously filed traditional certificate applications, protested WyCal's application. They argued that WyCal's rate proposal did not comply with the requirement that it assume the economic risks of the project, because it proposed a maximum reservation charge that included too large a share of its fixed costs. Kern River also objected to WyCal's proposal to levelize the proposed reservation charge.

124. In orders on WyCal's application issued in July and November 1988,¹⁵³ the Commission clarified the elements that must be present to satisfy the assumption of risk prerequisite for granting an optional expedited certificate, and the Commission modified WyCal's proposed rates consistent with that discussion. Of significance here, the Commission stated, "a sharing of the risk can be negotiated between the applicant and the customers for the new service so long as the customers are willing customers, and the negotiating process is at arm's length. The reservation fee established in an optional expedited certificate proceeding is a maximum reservation fee, and the pipeline and its customers are free to negotiate a reservation fee up to that level."¹⁵⁴ The Commission then described a negotiating process, prior to construction, under which customers agreeing to pay the highest net present value reservation charge per unit would have a higher priority in contracting for firm capacity on the proposed pipeline. The Commission stated that, among the contractual provisions which individual shippers could negotiate was the length of their contracts, enabling a shipper to increase the net present value of its bid by, for example, offering a 20-year contract term when other

¹⁵² The EOR operators in Kern County use steam injection technology to enhance the recovery of heavy crude oil. The operators sought access to natural gas in order to fuel the generators used to produce the needed steam.

¹⁵³ *WyCal*, 44 FERC ¶ 61,001, *reh'g granted in part*, 45 FERC ¶ 61,234 (1988).

¹⁵⁴ *WyCal*, 45 FERC at 61,677. The Commission also stated, "If the reservation fee is clearly negotiable, the pipeline is not guaranteed any revenue until the shipper agrees to pay the reservation charge. Therefore, the pipeline is at risk until a shipper agrees to pay an agreed-upon fee." *WyCal*, 44 FERC at 61,007.

bidders only offered a 10-year contract term. Upon completion of these negotiations, the applicant would decide whether to build the pipeline. The Commission then stated, “Future rate levels can change as a result of changes in the costs. Any such changes in the rates would stem from either section 4 or section 5 rate proceedings. Although we cannot bind the actions of future Commissions, *it is our intent that the negotiated rate design would not be subject to change in a future section 4 or section 5 rate proceeding, either by the applicant or by the Commission, because that rate design reflects the assignment of risk agreed to by the parties in order to construct the project.*”¹⁵⁵

125. The Commission also rejected Kern River’s contention that WyCal should not be permitted to levelize its reservation charge. Kern River argued that, for a pipeline with an increasing rate base, a levelized reservation fee could enable the pipeline to overcollect its fixed costs in the early years. The Commission responded,

Kern River is correct that the reservation fee is based upon a levelized cost-of-service concept. The Commission approved this method for the establishment of the maximum reservation fee which WyCal may negotiate. *The Commission established the reservation fee for the life of the project, subject to the outcome of the three-year rate review. Over the life of the project, WyCal will not overcollect its cost of service. Kern River has not persuaded us to utilize a different methodology to establish the maximum reservation fee.*¹⁵⁶

126. In response to Kern River’s request for clarification as to whether WyCal could increase its reservation charge through a subsequent section 4 filing, the Commission stated,

We further clarify that the maximum reservation fee can be increased in the future through a section 4 rate proceeding, but only if such increase is cost supported. However, as stated above, *the negotiated rate design can not be open to change, either by WyCal or, we anticipate, by the Commission.*¹⁵⁷

¹⁵⁵ *WyCal*, 45 FERC at 61,678 (emphasis supplied).

¹⁵⁶ *WyCal*, 45 FERC at 61,679-680 (emphasis supplied)

¹⁵⁷ *Id.* 61,680 (emphasis supplied).

127. The Commission rejected WyCal's proposal to base its rates on a projected 15-year depreciable life, finding that its proposed facilities would have at least a 25-year economic life. However, the Commission stated that it would allow WyCal to recover all of its debt service in the first 15 years, with return of equity to come mainly in the following 10 years. The Commission accordingly held that it would permit WyCal to charge one maximum rate for the first 15 years of service, another rate for years 16-25, and a third rate for the time after 25 years. The Commission redetermined WyCal's maximum rates consistent with these holdings, setting forth the maximum rates approved "for any service rendered during" each of the three periods in the same manner as the Commission subsequently set forth Kern River's approved maximum rates.

128. Thus, in finding that WyCal had satisfied the risk assumption requirement of the optional expedited certificate regulations and approving WyCal's certificate application without the usual investigation of such issues as the market need for the project, the Commission considered WyCal's proposed maximum rates for the life of its project, not just the rates to be in effect for the terms of its initial contracts with its shippers. For example, in rejecting Kern River's objections to WyCal's proposed levelized reservation charge, the Commission expressly stated that it had "established the reservation fee for the life of the project" and that a levelized rate would not overcollect WyCal's cost of service "over the life of the project." The Commission said this, while also recognizing that the length of the shippers' initial contracts was subject to negotiation and those contracts could terminate well before the end of the project's life.¹⁵⁸

129. The Commission also stated its "intent that the negotiated rate design would not be subject to change in a future section 4 or section 5 rate proceeding, either by the applicant or by the Commission, because that rate design reflects the assignment of risk agreed to by the parties in order to construct the pipeline."¹⁵⁹ The Commission did not limit this statement to the terms of the shippers' initial contracts. Moreover, the Commission emphasized that any sharing of risk by WyCal's customers must be willingly agreed to by those customers in an arms length negotiation. A unilateral section 4 filing by the pipeline to modify the rate design approved in the certificate order, including the levelized rate methodology approved for the life of the project, would be inconsistent with this principle. That is because such a rate design change would be imposed on the customers, rather

¹⁵⁸ For example, the Commission stated a shipper might bid for a 10-year contract, despite finding that the life of the project is at least 25 years.

¹⁵⁹ *WyCal*, 45 FERC at 61,678.

than willingly agreed to in an arms length negotiation. The Commission thus allowed WyCal the benefit of the presumption that its project satisfied the statutory prerequisites for granting a certificate under NGA section 7 based on its willingness to proceed with the project subject to the rate design approved in the certificate orders, a rate design which the Commission intended to continue for the life of the project.

130. Kern River filed its request for an optional expedited certificate in 1989, after the Commission had issued its two orders determining that WyCal had satisfied the conditions for an optional expedited certificate.¹⁶⁰ Kern River proposed to use generally the same rate design as the Commission had approved for WyCal, including a depreciable life of 25 years, a 70 percent/30 percent debt equity ratio, and levelized rates to recover 70 percent of its investment during the first 15 years of the project's life. In ruling on Kern River's application, the Commission recognized that Kern River, Mojave, and WyCal were competing to serve the same EOR market, and the Commission accordingly found that the three pipelines should be accorded comparable regulatory treatment.¹⁶¹ The Commission therefore granted Kern River's optional expedited certificate application, based on the same rate conditions as established in *WyCal*. As in *WyCal*, the Commission "redetermined" Kern River's proposed rates, setting forth separately the maximum rates to apply "for any services rendered during the first 15-year period," "for any services rendered during the next 10-year period," and "for any services rendered after 25 years from Kern River's in-service date."¹⁶² The Commission found that this "rate structure will enable Kern River to recover all of its debt service during the first 15 years, and to recover its return on equity primarily during the second period. Debt service is levelized throughout the first period, while the depreciation schedule is maintained at 25 years. Kern River will assume the risk of recovery of depreciation not recovered in the first 15 years."¹⁶³

¹⁶⁰ Kern River filed its application jointly with Mojave, which filed to amend its previously granted optional expedited certificate consistent with a settlement between the two pipelines to coordinate their proposals to jointly serve the California EOR market.

¹⁶¹ Original Certificate Order, 50 FERC ¶ 61,069 at 61,150.

¹⁶² *Id.* 61,150-151.

¹⁶³ *Id.* 61,150.

131. In addition, in a January 1992 Order granting Kern River's request to amend its certificate to increase its initial rates to reflect updated cost estimates of constructing its Original System, the Commission expressly clarified that this rate design included levelized rates for Period Two. The Commission stated, "*The levelized rates will enable Kern River to recover substantially all of its debt capital during the first 15 years (Period One) and its equity capital during the next ten years [Period Two].*"¹⁶⁴ The Commission also stated that "*Kern River's rates are based on two levelized calculations, one for the first fifteen years and the other for the next ten years.*"¹⁶⁵

132. It follows that, as in *WyCal*, the Commission approved a rate design for Kern River that the Commission intended to continue for the life of the project, not just the terms of the initial contracts, and this rate design was the basis for the Commission's holding that Kern River had satisfied the risk assumption requirement of the optional expedited certificate regulations. Kern River thus obtained the benefit of the presumption that its project satisfied the statutory prerequisites for granting a certificate under NGA section 7 based on its willingness to proceed with the project subject to the rate design approved in the certificate orders. Moreover, on rehearing of the Original Certificate Order, the Commission stated that its holding in *WyCal* concerning the pipeline's ability to make a future section 4 filing applied to Kern River.¹⁶⁶ Thus, as stated in *WyCal*, Kern River could file to increase its rates to reflect increased costs, but the Commission's intent was that the rate design would not be subject to unilateral changes in a future section 4 proceeding.

133. Kern River recognized that its optional expedited certificate was granted subject to the same conditions and rate design as the optional expedited certificate previously granted *WyCal*. In fact, in its request for rehearing of the Amended Certificate Order, Kern River stated that in deciding to apply for an optional expedited certificate, it "analyzed the risk-reward framework established for optional expedited certificates pipelines in the" *WyCal* orders.¹⁶⁷ Kern River

¹⁶⁴ Amended Certificate Order, 58 FERC ¶ 61,234 at 61,242 (emphasis supplied).

¹⁶⁵ *Id.* 61,244 n.38 (emphasis supplied).

¹⁶⁶ *Kern River Gas Transmission Company*, 51 FERC ¶ 61,195, at 61,539 (1990).

¹⁶⁷ March 2, 1992 Request for Rehearing by Kern River in Docket No. CP89-2048-008 at 4.

stated that among the “four fundamental principles established by those orders” was that “the pipeline may levelize its cost of service by varying the annual depreciation expense and may design the levelized reservation fee by taking a simple average of the annual reservation charges over the levelized period.”¹⁶⁸ Kern River then carefully analyzed the consistency with *WyCal* of the rates the Commission approved in its order amending Kern River’s certificate for both Periods One and Two. As discussed in detail in the next section of this order, Kern River asserted that the Commission had departed from the rate design established in *WyCal* not only with respect to Period One, but also in two matters concerning Period Two unrelated to the Amended Certificate Order’s clarification that Period Two rates be levelized. Kern River asserted that these changes “represent a fundamental reversal of *the Commission’s commitment in [Kern River’s initial Optional Expedited] Certificate Order not to adjust the rate design that allowed the pipeline to be constructed,*” and Kern River also quoted the Commission’s statement in *WyCal* that “*it is our intent that the negotiated rate design would not be subject to change in a future Section 4 or Section 5 proceeding.*”¹⁶⁹ The Commission granted Kern River’s rehearing request.

134. In these circumstances, the Commission finds that our orders granting Kern River an optional expedited certificate created a strong presumption that the rate design approved in its certificate proceeding would continue for the life of the project, regardless of the term of the shippers’ initial service agreements. That rate design provided the basis for the Commission’s holding that Kern River had satisfied the risk assumption requirement underlying the Commission’s optional expedited certificate procedures. The Commission thus allowed Kern River the benefit of the presumption that its project satisfied the statutory prerequisites for granting a certificate under NGA section 7, based on its willingness to proceed with the project subject to the rate design approved in the certificate orders. This allowed Kern River to avoid the usual investigation of such issues as the market need for the project. Having granted Kern River its certificate on this basis, the Commission could reasonably expect Kern River to maintain the rate design that provided the basis for granting the certificate.

135. The Commission made this expectation clear, when it stated that, while it could not bind future Commissions, it intended that the rate design approved in the certificate proceeding would not be subject to unilateral changes in a future section

¹⁶⁸ *Id.*

¹⁶⁹ Kern River’s March 2, 1992 Request for Rehearing of the January 1992 Certificate Amendment Order at page 12 and n.3 (emphasis supplied).

4 proceeding. Indeed, the *WyCal* and *Kern River* certificate orders contain some language that could be interpreted as prohibiting any unilateral section 4 filing proposing a change in rate design.¹⁷⁰ However, we do not interpret the orders, which were both affirmed by the courts,¹⁷¹ as going that far. For example, when the Commission stated in *WyCal* that “it is our intent that the negotiated rate design would not be subject to change in a future section 4 or section 5 rate proceeding,” the Commission also recognized that “we cannot bind the actions of future Commissions.”¹⁷² Moreover, a statement of “intent” is not the equivalent of a binding condition prohibiting section 4 filings. We thus need not reach the issue of the extent of the Commission’s authority under NGA section 7(e) to issue a certificate subject to a condition prohibiting a pipeline from making certain types of section 4 filings concerning the rates for the certificated facility.¹⁷³

136. Our approach here is similar to that taken in a section 4 rate case filed by Mojave Pipeline Co., where we stated that, once the Commission has issued an optional expedited certificate, “the Commission will not lightly change the allocation of risk inherent in the optional certificate as granted,” absent some “overarching policy reason.”¹⁷⁴ Requiring parties seeking a change in the rate

¹⁷⁰ For example, *WyCal* stated, “the negotiated rate design can not be open to change . . . by *WyCal*.” *WyCal*, 45 FERC at 61,680.

¹⁷¹ *CPUC v. FERC*, 900 F.2d 269 (D.C. Cir. 1990), affirming the *WyCal* orders. *Pacific Gas Transmission Co. v. FERC*, 998 F.2d 1303 (5th Cir. 1993), affirming the *Kern River* orders.

¹⁷² *WyCal*, 45 FERC at 61,678.

¹⁷³ Section 7(e) provides, “The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.”

¹⁷⁴ *Mojave Pipeline Co.*, 81 FERC ¶ 61,150, at 61,682-683 (1997). During *Kern River*’s restructuring pursuant to Order No. 636, the Commission required *Kern River* to shift from the Modified Fixed Variable rate design approved in the Optional Expedited Certificate proceeding to a Straight Fixed Variable rate design. The Commission found that the need to accomplish the important national policy goals established by Order No. 636 outweighed any adverse effect of a change in the allocation of the risk under the *Kern River* project. *Kern River Gas Transmission Company*, 62 FERC ¶ 61,191, *reh’g denied*, 64 FERC ¶ 61,049 (1993), *aff’d* *Union Pacific Fuels, Inc. v. FERC*, 129 F.3d 157 (D.C. Cir. 1997).

(continued...)

design approved in the certificate proceeding in a section 4 or 5 proceeding to overcome a presumption that the rate design will continue for the life of the project also respects the reliance interests of both the pipeline and its shippers. Kern River made clear in its request for rehearing of the Certificate Amendment Order that it relied on “the Commission’s commitment in the Certificate Order not to adjust the rate design” in deciding to proceed with the project. Similarly, the shippers who decided to execute contracts for service on Kern River’s project, rather than contracting with a competing project, could reasonably rely on the Commission’s statements in the certificate orders of its intent that the approved rate design not be subject to change in a section 4 or 5 proceeding.

137. The Commission concludes that the circumstances of Kern River’s certification described above create a strong presumption, applicable in any subsequent section 4 or 5 proceeding, that the rate design underlying the Commission’s approval of Kern River’s optional expedited certificate would continue for the life of the project.¹⁷⁵

b. Interpretation of Certificate Orders

138. Even assuming the Commission’s orders in Kern River’s certificate proceeding established rate design principles intended to apply for the life of its project, as we have found in the preceding section, Kern River asserts that Opinion No. 486-C misinterpreted the certificate orders as holding that Period Two rates would be levelized.

139. In finding that the January 1990 Original Certificate Order held that the Period Two rates would be levelized, Opinion No. 486-C explained that the order:

authorized Kern River “to charge one rate for its first 15 years of service, another rate for years 16 through 25, and a third rate for service rendered after 25 years.”¹⁷⁶ The Commission also calculated

No party in this proceeding has asserted any similar policy reason requiring a change in the levelized rate methodology approved in the optional expedited certificate proceeding.

¹⁷⁵ Opinion No. 486-A (*citing Mojave Pipeline Co.*, 81 FERC ¶ 61,150 (footnote omitted)).

¹⁷⁶ Original Certificate Order, 50 FERC ¶ 61,069, at 61,150 (1990).

the three sets of rates and included them in the certificate order.¹⁷⁷ While the Original Certificate did not explicitly describe the calculated Period Two rates as levelized, the fact the Commission required a single, level rate to be applied throughout the ten years of Period Two necessarily carried with it a determination that the Period Two rates would be levelized. If the Commission had calculated the required Period Two rates based on a traditional rate methodology, those rates would have allowed Kern River to substantially overrecover its allowed return on equity during Period Two. That is because under a traditional rate methodology, the return on equity would have been calculated as a return on Kern River's rate base as of the end of Year 15, without regard to the decline in the rate base during Period Two to zero at the end of Year 25.¹⁷⁸

140. Opinion No. 486-C also found that this interpretation of the Original Certificate Order is confirmed by the Commission's January 30, 1992 Order in the optional expedited certificate proceeding, granting Kern River's request to amend the Original Certificate Order to reflect Kern River's updated cost estimates (Amended Original Certificate Order). Among other things, Opinion No. 486-C pointed out that the January 30, 1992 order set forth a table reflecting the plant cost recovery percentages which were to underlie Kern River's authorized rates. The Commission's description of this Table clearly set forth its understanding that the levelized methodology was to be used in all rate periods associated with this project when it stated, "[T]he sudden drop in plant recoveries in year 16 occurs because Kern River's rates are based upon *two levelized calculations, one for the first fifteen years and the other for the next 10 years.*"¹⁷⁹

Kern River's Rehearing Request

141. Kern River contends that Opinion No. 486-C's interpretation of the Original Certificate Order as approving levelized rates in Period Two is incorrect, because it relies solely on that order's statement of the same rate for every year of the period comprising years 16-25 of Kern River's then-anticipated service life, *i.e.*, the years then expected to comprise Period Two. Kern River argues that the

¹⁷⁷ *Id.* 61,151.

¹⁷⁸ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 249.

¹⁷⁹ *Id.* 61,244 n.38 (emphasis added).

Original Certificate Order's statement of the same rate for every year in Period Two does not show that the Commission intended the Period Two rate to be levelized. Kern River argues that an unchanging rate, despite a declining rate base, is also typical of traditionally derived rates. Kern River points out that the Commission establishes traditional rates as of a particular point in time, and those rates remain the same every year – regardless of declines in rate base - until and unless they are changed by the pipeline or the Commission. Kern River also argues that other portions of the Original Certificate Order expressly acknowledged that Kern River proposed levelized rates only for the first 15 years of its life corresponding with Period One and that the August 1992 Order granting rehearing of the January 1992 Certificate Amendment Order stated that the Commission accepted the revised 15-year levelized rates that Kern River proposed in its application to amend its original certificate. Based on these reasons, Kern River asserts that “the Original Certificate Order’s unexplained, uniform rate for years 16-25 of Kern River’s expected life falls well short of establishing a requirement that Period Two rates must be levelized.”¹⁸⁰

Commission Determination

142. Contrary to Kern River’s contentions, we find that the Commission’s orders in the optional expedited certificate proceeding approved a rate structure for Kern River not only for Period One, but also for Periods Two and Three, and the rate structure approved by those orders included levelized rates for both Period One and Period Two. Despite Kern River’s efforts to characterize the certificate orders as making no findings concerning its rates after Period One, the Original Certificate Order expressly stated that the Commission “will authorize Kern River to charge one rate for its first 15 years of service, another rate for years 15 through 25, and a third rate for service rendered after 25 years,” and the Commission calculated the rates for each of those periods. While Kern River focuses on the fact the Original Certificate Order did not expressly state that the single rate to apply throughout Period Two was levelized, whatever ambiguity may have existed in the Original Certificate Order concerning the use of levelized rates in Period Two was fully clarified in the January 1992 Amended Certificate Order.

143. The January 1992 Order addressed Kern River’s request to amend its certificate to increase its initial rates to reflect updated costs estimates of constructing its Original System. The Commission found the updated estimates to be reasonable, and therefore stated that it had “redetermined Kern River’s rates, based on . . . the rate methodology principles approved for Kern River in its

¹⁸⁰ Kern River Rehearing Request at 29.

previous certificate orders.”¹⁸¹ The Commission again stated that it would “authorize” Kern River to use a levelized cost of service and charge different rates for Periods One, Two, and Three. The Commission stated, “*The levelized rates will enable Kern River to recover substantially all of its debt capital during the first 15 years (Period One) and its equity capital during the next ten years [Period Two].*”¹⁸²

144. After setting forth the revised rates it was authorizing for each of the three periods, the Commission turned to an explanation of how Kern River would recover its plant costs under the authorized rates. The Commission pointed out that, because it had found that Kern River’s depreciable life would be 25 years, the Commission had prescribed an annual depreciation rate for Kern River of 4 percent pursuant to NGA section 9. However, under the levelized rate methodology, Kern River’s rate recovery of plant costs would vary. The Commission then stated that it “perceives that this has led to confusion regarding the recovery of plant costs by pipelines with levelized costs of service.”¹⁸³ Accordingly, “in order to avoid confusion,” the Commission set forth the schedule of plant cost recovery percentages “which underlie Kern River’s authorized rates” for each of the 25 years of its depreciable life.¹⁸⁴ Under that schedule, Kern River’s plant cost recoveries rose from 0.6433 percent in Year 1 to 10.1698 percent in Year 15, the last year of Period One. They then dropped to 2.1688 percent in Year 16, the first year of Period Two and gradually rose again to 4.2900 percent in Year 25, the last year of Period Two. The Commission explained that “the above plant cost recoveries vary from year to year because they are calculated using a present value methodology . . . The sudden drop in plant cost recoveries in year 16 occurs because *Kern River’s rates are based on two levelized calculations, one for the first fifteen years and the other for the next ten years.*”¹⁸⁵

145. Thus, regardless of the Original Certificate Order’s statements that (1) “Kern River propose[d] . . . to levelize its costs and rates for the first 15 years of the project’s life,” and (2) “the Commission will permit Kern River to utilize a

¹⁸¹ 58 FERC at 61,242.

¹⁸² *Id.* 61,242.

¹⁸³ *Id.* 61,243.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* 61,244 n.38 (emphasis supplied).

levelized cost of service for a period of 15 years,”¹⁸⁶ the Amended Certificate Order made clear that the Commission was approving a rate methodology for the life of Kern River’s Original system which included levelized rates for both Periods One and Two. Otherwise, there would have been no reason for the Commission’s detailed explanation in the Amended Certificate Order of the approved levelized rate methodology and how it would be applied in both Periods One and Two.

146. Kern River points out that in August 1992 the Commission granted Kern River’s request for rehearing of the Amended Certificate Order, and found that the rates proposed in Kern River’s application to amend its Original Certificate complied with the rate principles established in the January 1990 Original Certificate order and the January 1992 Certificate Amendment Order.¹⁸⁷ Since Kern River only included rates for Period One in that application, Kern River contends in its instant rehearing request that the August 1992 rehearing order effectively removed any requirement that might have been contained in the earlier orders that its Period Two rates be levelized.

147. A review of both Kern River’s March 2, 1992 request for rehearing of the Certificate Amendment Order and the August 1992 Order granting that request demonstrates that Kern River neither sought, nor did the Commission make, any change in its holding that the Period Two rates would be levelized. After issuance of the January 1992 Certificate Amendment order, the Commission provided to Kern River Staff’s work papers used in determining the rates and plant recovery schedule set forth in that order. Kern River included those work papers in an appendix to its request for rehearing of that order. As demonstrated by Kern River’s request for rehearing of the Certificate Amendment Order, it very carefully analyzed Staff’s work papers to determine the extent to which Staff’s calculations were inconsistent with “the risk-reward framework established for optional certificate pipelines in the *WyCal I* order and the certificate order”¹⁸⁸ for Kern River, upon which Kern River stated it and its lenders had relied in deciding to proceed with the project. The first page of the Staff work papers included among the “assumptions” underlying Staff’s calculations, “Depreciation Rates were

¹⁸⁶ 50 FERC at 61,146 and 61,150, *cited* by Kern River at page 29, n. 36 of its rehearing request.

¹⁸⁷ *Kern River Gas Transmission Co.*, 60 FERC ¶ 61,123 at 61,437 (1992).

¹⁸⁸ March 2, 1992 Kern River Rehearing Request in Docket No. CP89-2048-008 at 4.

levelized over the twenty-five years,” representing the then expected life of the project including both Periods One and Two. While Kern River found various instances where Staff’s calculations did not follow the rate design principles established in the Commission’s earlier optional expedited certificate orders, Kern River did not take issue with the levelization of its Period Two rates.

148. Most of Kern River’s rehearing request focused on its rates during Years 1 through 15, which then comprised Period One. Kern River asserted that the rate design principles approved in *WyCal I* and the Original Certificate Order included that it “may levelize its cost of service by varying the annual depreciation expense . . .” and “may structure its capital recovery consistent with the financial market for project financed debt so that it can be financed with 70 percent debt to be repaid over the first 15 years of the project’s life.”¹⁸⁹ Kern River asserted that the depreciation methodology the Commission used for Years 1 through 15 was flawed in several important respects, with the result that it failed to permit Kern River to recover 70 percent of its plant costs during the first 15 years, so as to permit it to repay its debt. Among other things, Kern River asserted that Staff’s work papers indicated that its levelization methodology improperly assumed “that debt and equity are retired ratably each year and ignores the reality that Kern River’s capital structure changes during each of the 15 years of the project as debt principal is retired.”¹⁹⁰

149. After discussing this and other flaws in the January 1992 Certificate Amendment Order’s calculation of its Period One rates, as shown by the Staff’s work papers, Kern River then turned at the end of its rehearing request to the determination of its rates during Years 16-25, which then comprised Period Two. Kern River asserted that there were two errors in the determination of its Period Two rates. First, Kern River stated that the work papers showed that the Commission used an overall rate of return of 11.2 percent for Period Two. However, this failed to recognize that during Period Two Kern River’s capital structure would consist entirely of equity, because its debt was to be paid in full in the first 15 years. Therefore, Kern River asserted, the appropriate return to be used for Period Two was Kern River’s allowed return on equity, which was then 14 percent. Second, Kern River asserted that the Commission had miscalculated its O&M and A&G expenses during Period Two, because the Commission had reduced its annual inflation factor from 3 percent during Period One, to 2.9 percent as of Year 16, the start of Period Two, without explanation. While

¹⁸⁹ March 2, 1992 Kern River Rehearing Request at 4.

¹⁹⁰ *Id.* at 23-24.

pointing to these two errors in the calculation of its Period Two rates, Kern River did not contest the levelization of its Period Two rates, despite the fact the Staff's work papers clearly indicated that those rates would be levelized.

150. In the August 1992 Order, the Commission granted Kern River's rehearing request, agreeing that the rate methodology used in the January 1992 Certificate Amendment Order had improperly maintained the 70/30 debt/equity ratio throughout the life of Kern River's project. However, after agreeing that during Period Two Kern River would be capitalized entirely with equity, the Commission did state that it was concerned that in the latter years of the project the 14 percent return on equity being authorized for the project would no longer be appropriate, and therefore the Commission reserved its right to examine this issue in a general section 4 rate case. Kern River having not contested the January 1992 order's determination that Kern River's levelized rate design methodology applied to Period Two as well as Period One, the August 1992 Order did not reconsider that determination. Thus, nothing in that order modified the January 1992 Certificate Amendment Order's approval of a rate design methodology for Kern River under which "Kern River's rates are based on two levelized calculations, one for the first fifteen years and the other for the next ten years."¹⁹¹

151. Kern River contends that the Commission's holding that the Original Certificate Order required levelization in Period Two is undercut by the Commission's rationale for rejecting arguments that its certificate orders required Kern River to use its collection of depreciation expense to retire all debt before the start of Period Two. Specifically, Kern River points out that Opinion No. 486-A found that "statements in past Commission orders, such as that the Period One rates 'will enable Kern River to recover all of its debt service'¹⁹² (or that 'rates have been designed based on levelizing the cost of service over the debt repayment period',¹⁹³ did not constitute requirements that Kern River actually pay off its debt during that period."¹⁹⁴ Kern River states that the Commission determined that if the certificate orders had intended, contrary to the Commission's usual practice, to actually require Kern River to pay off its debt

¹⁹¹ Certificate Amendment Order, 58 FERC at 61,244 n.38.

¹⁹² Kern River Rehearing Request at 30 (*citing* 50 FERC at 61,069).

¹⁹³ *Id.* (*citing* 92 FERC ¶ 61,061 at 61,159).

¹⁹⁴ Kern River Rehearing Request at 30 (*citing* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 43).

during Period One, the orders would have set forth that requirement more clearly.¹⁹⁵ Kern River argues that, similarly, at the time of the certificate orders, the Commission had never imposed a levelized cost of service or rates on a pipeline that did not propose them. Therefore, Kern River argues that if, “contrary to the Commission’s usual practice,” the Original and Certificate Amendment Orders had, in fact, intended to require levelization in Period Two the Commission would have set forth this requirement more clearly.

152. The Commission rejects this contention. First, Kern River’s premise is incorrect because in *Ozark*, issued in February 1990 almost two years before the January 1992 Certificate Amendment Order, the Commission imposed levelized rates on a pipeline that did not propose levelized rates.¹⁹⁶ Second, as described in detail above, the orders in the certificate proceeding could hardly have been clearer that the Commission was approving a rate methodology for the life of Kern River’s Original System which included levelized rates for both Periods One and Two. There is nothing in the August 1992 Order to suggest that the Commission was making such a fundamental change to its prior holdings as to permit elimination of the levelized rate structure at the end of Period One and the use of traditional rates during Period Two. If the Commission had intended such a fundamental change in the approved initial rates, it would have expressly stated that intention.

153. Finally, Kern River points to nothing in the Commission’s approval of the Extended Term Settlement or the subsequent orders certifying the 2002 and 2003 Expansions modifying the original intent that Period Two rates be levelized. Those subsequent proceedings all carried forward the original risk sharing agreement, with the exception that shippers were offered the option of 10 or 15-year contracts for Period One. Otherwise, all aspects of the agreement remained the same, with levelized rates for Period One recovering 70 percent of the relevant invested capital and levelized rates for Period Two recovering the remaining 30 percent of invested capital.

¹⁹⁵ *Id.*

¹⁹⁶ *Ozark Gas Transmission System*, 50 FERC ¶ 61,252 (1990) (requiring a pipeline to implement levelized rates to ensure that its shippers received the benefit of its declining rate base). *See Trailblazer Pipeline Co.* 50 FERC ¶ 61,188, at 61,586-587 (1990) (requiring a pipeline to implement levelized rates to ensure that its shippers received the benefits of its declining rate base).

c. **Traditional Rates for Period Two Are Not Just and Reasonable**

154. In the preceding two sections of this order, the Commission has found that the orders approving Kern River's optional certificate created a strong presumption, applicable in any subsequent section 4 or 5 proceeding, that the rate design underlying the Commission's approval of Kern River's optional expedited certificate, including levelized Period Two rates, would continue for the life of the project. While the certificate orders did not impose an absolute prohibition on Kern River or others seeking a change in rate design in subsequent section 4 or 5 proceedings, the circumstances of Kern River's certification are a significant factor that must be taken into account in determining whether any proposed change is just and reasonable.

155. Kern River has provided no basis for overcoming the presumption that the rate design underlying the approval of its optional expedited certificate should continue during Period Two. It has thus failed to justify its proposal to use a traditional rate design for its Period Two rates. Aside from the facts that (1) the Commission granted Kern River's optional expedited certificate based on its willingness to proceed with the project using the rate design approved in the certificate orders and (2) the shippers' reliance interest on the maintenance of that rate design, there are additional reasons why the Commission finds that a shift to a traditional rate design in Period Two is not just and reasonable. For the reasons discussed below, Kern River's Period One and Two rates are interrelated with one another in such a way that, absent some change in circumstance which has not been shown, the two must be designed in the same manner.

156. Under a traditional rate design, the Commission awards a return based on the rate base existing at the end of the test period, and subsequent declines in the rate base as depreciation is recovered are not taken into account unless and until the pipeline files a new NGA section 4 rate case. Levelizing a pipeline's rates over its life provides lower rates at the initiation of service than a traditional rate making methodology but, over time as the traditional rate base declines, the levelized rate will become higher than traditionally designed rates. In essence, levelization is accomplished by the pipeline deferring to later years recovery of costs that would otherwise be recoverable early in its life.

157. Kern River's levelized rates, as approved in the certificate proceeding, have the unusual feature of levelizing its rates over two different periods, so that Kern River can recover 70 percent of its invested capital during Period One. However, Kern River will not have reached 70 percent of its depreciable life at the end of Period One. As a result, unlike the usual situation with levelized rates, Kern River's levelized rates will have recovered more of its invested capital during

Period One than it would under ordinary straight-line depreciation, or than traditional rates would have recovered at that stage of Kern River's life. The levelized Period One rates thus benefitted Kern River in two ways. On the one hand, they helped Kern River compete with the other pipelines seeking to serve the California EOR market by allowing it to offer lower initial rates than if it had used a traditional rate design. However, at the same time, the levelized Period One rates provided Kern River the funds to repay its loans used to finance 70 percent of its construction costs during the terms of the shippers' initial contracts. As already discussed, both Kern River and its lenders relied on this aspect of the levelized rate methodology in proceeding with the project.

158. The fact that Kern River's Period One rates have been designed to recover more of its invested capital during that period than would have otherwise been properly allocated to that period carries with it an obligation for Kern River to return that excess recovery to its shippers during Period Two, through the step-down rates to be implemented at the start of Period Two.¹⁹⁷ In fact, in approving Kern River's proposal to continue its levelized rate methodology for Period One over BP's objection, the Commission held, "we can only find the Period One rates to be just and reasonable, if Kern River's tariff also provides for the return of the excess recovery in its Period One rates."¹⁹⁸

159. Kern River suggests that the excess recovery in Period One can be returned through traditional rates, and therefore the Period Two rates need not be levelized in order to provide for that return. As explained in Opinion Nos. 486 and 486-A, Kern River's excess recovery of its invested capital at the end of Period One is accounted for as a regulatory liability.¹⁹⁹ It is true that, whether traditional or levelized rates are used for Period Two, the regulatory liability will be subtracted from the starting rate base used to determine the return on equity to be included in the Period Two rates. However, as Kern River itself recognizes elsewhere in its rehearing request, "the Commission establishes traditional rates as of a particular

¹⁹⁷ The excess recovery of invested capital during Period One is accounted for as a regulatory liability. That regulatory liability will be subtracted from the starting rate base used to determine the return on equity to be included in the Period Two rates.

¹⁹⁸ Opinion No. 486-A, 123 FERC ¶ 61,056 at P 61.

¹⁹⁹ Opinion No. 486, 117 FERC ¶ 61,077 at P 47-48; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 28.

point in time, and those rates remain the same every year – *regardless of declines in rate base* – until and unless they are changed by the pipeline or the Commission.”²⁰⁰ Therefore, Kern River’s proposal to use traditional rates during Period Two would permit it to earn a return on equity (plus associated taxes) on its entire Period Two starting rate base during every year of Period Two, unless and until those rates were changed in a general section 4 rate case or under NGA section 5. This would occur despite the fact the Period Two rates will be designed to recover a portion of the rate base every year, until the rate base declines to zero at the end of Period Two. By contrast, levelized Period Two rates would be designed to reflect the decline in rate base during Period Two, thereby providing Kern River a return on equity every year based on its actual projected net rate base during the year in question.

160. Kern River’s proposal to shift to a traditional rate design during Period Two would thus give it the best of both worlds. Its levelized Period One rates would enable it to recover more of its investment in the facilities subject to those rates than is properly allocated to Period One, thereby giving it the funds to repay its lenders. Traditional rates in Period Two would then likely permit Kern River to earn an excessive return on equity on its remaining investment, because there would almost undoubtedly not be section 4 or 5 proceedings every year to modify the Period Two rates to reflect Kern River’s declining rate base.

161. Our concern on this score is heightened by the fact that, as described above, the rate design methodology approved in the optional expedited certificate proceeding results in the Period Two rate base being financed entirely by equity. The Commission has long recognized that an equity-rich capital structure increases costs to ratepayers, because a pipeline’s cost of equity is higher than its cost of debt.²⁰¹ Therefore, the Commission ordinarily would not approve the use of a 100 percent equity capital structure.²⁰² However, as previously discussed, the

²⁰⁰ January 2010 Kern River Request for Rehearing at 28 (emphasis supplied).

²⁰¹ See *Transcontinental Gas Pipe Line Corp.*, 71 FERC ¶ 61,305 (1995); see also Opinion No. 414-A, 84 FERC at 61,412.

²⁰² For example, in the following cases, the Commission imputed a capital structure, because the actual capital structures claimed by the pipelines exceeded a reasonable level. See *KansOk Partnership*, 71 FERC ¶ 61,340 (1995) (The Commission imputed a 50-50 capital structure after finding that both KansOk and the pipeline that provided its financing had atypical capital structures of 100 and

(continued...)

Commission's August 1992 Order in the optional expedited certificate proceeding granted Kern River's request to clarify that its Period Two rates could be designed using a 100 percent capital structure.²⁰³ That holding followed from the fact that the Period One rates are intended to permit Kern River to pay off its entire debt. While a 100 percent equity capital structure is an integral part of the overall rate design approved by the Commission in the optional expedited certificate, the use of such a capital structure makes it all the more important to design the Period Two rates in a manner that reflects the decline in its rate base during that period. Otherwise, the Period Two rates would enable Kern River to earn an excessive return on equity, contrary to the Commission's intent in the optional expedited certificate proceeding when it required that the Period Two rates be leveled.

162. The Commission concludes that the rate design principles approved in the optional expedited certificated proceeding, with leveled rates for both Periods One and Two which reflect the projected changes in capital structure over the life of the project, work together as an integrated whole to produce just and reasonable rates for the life of a project. Kern River's proposal in this proceeding to depart from those principles and use a different rate design for Period Two than for Period One would produce an unjust and unreasonable result. It would include a built-in overrecovery of Kern River's return on equity during Period Two and is contrary to the reasonable expectations of all concerned when Kern River decided to proceed with the project and its shippers entered into their initial contracts. The shippers having agreed in their initial contracts to pay rates which would enable Kern River to pay off its entire debt, they could reasonably expect to be offered service during Period Two at rates designed in a manner consistent with the rate design principles set forth in the optional expedited certificate orders. Kern River has not shown any change in circumstance or overarching policy reason which would justify a departure from those rate design principles in this proceeding.

90 percent equity, respectively); *Louisiana Intrastate Gas Corp.*, 50 FERC ¶ 61,011 (1990) (55 percent equity); *Tarpon Transmission Co.*, 41 FERC ¶ 61,044 (1987) (45 percent equity); *Alabama-Tennessee Natural Gas Co.*, 38 FERC ¶ 61,251 (1987) (45 percent equity).

²⁰³ This assumes that Kern River does not refinance its debt. See Opinion No. 486-A, 123 FERC ¶ 61,056 at P 142.

d. **Coordination of Levelization Period and Contract Terms**

163. In Opinion No. 486-C, the Commission addressed concerns raised by Kern River that none of its shippers currently have contracts for service during Period Two and that this prevented it from calculating levelized rates for Period Two. Kern River asserted that Commission policy requires that a levelized cost of service must be coterminous with the contracts under which a pipeline's shippers will take service at levelized rates.²⁰⁴

164. The Commission determined that Kern River's characterization of the Commission's general levelized rate policy was incorrect. The Commission pointed out that Kern River's contention that Commission policy only permitted levelized rates if shippers have contracts for the entire levelization period confused the accounting requirements for regulatory asset treatment with levelized rates. Further, the Commission stated that the *Ingleside* and *Southern Trails* orders were limited to the holding that the levelized rate proposals in those cases did not meet the probability of recovery requirement in its accounting regulations to record a regulatory asset. However, the Commission noted that in both *Ingleside* and *Southern Trails*, the Commission approved the pipelines' proposals to charge rates levelized over periods longer than the shippers' contract terms.²⁰⁵ In *Corpus Christi* the Commission permitted a period shorter than shippers' contracts.²⁰⁶ In addition, the Commission stated that it has previously permitted levelized rate

²⁰⁴ See Opinion No. 486-C, 129 FERC ¶ 61,240 at P 254 (*citing Ingleside Energy Ctr., LLC*, 112 FERC ¶ 61,101, at P 76-78 (2005) (*Ingleside*); *Corpus Christi LNG, L.P.*, 111 FERC ¶ 61,081, at P 30-32 (2005) (*Corpus Christi*); *Questar Southern Trails Pipeline Co.*, 89 FERC ¶ 61,050, at 61,147 (1999) (*Southern Trails*)).

²⁰⁵ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 255 (*citing Ingleside*, 112 FERC ¶ 61,101 at P 27 (stating "The Commission has reviewed the proposed cost-of-service and proposed initial rates, and generally finds them reasonable for a new pipeline entity, such as San Patricio, subject to the conditions discussed below."); *Southern Trails*, 89 FERC at 61,148 (stating "Southern Trails should keep records which are not part of its financial statements that support the rate treatment of the unrecovered costs even though they are not recordable as a regulatory asset.")).

²⁰⁶ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 256.

treatment not linked to any specific contract term, particularly in situations where it was faced with a pipeline that had a rapidly declining rate base.²⁰⁷

165. However, Opinion No. 486-C stated that it does not follow from the fact that Commission policy permits rates to be levelized over a longer period than the terms of shipper contracts that there should be no coordination in this case between the duration of shipper contracts for service during Period Two and the length of the Period Two rate levelization period. The Commission stated that, while Kern River's Period Two rates must be levelized, the present record contained no indication that during the optional expedited certificate proceeding, the parties had fully considered or agreed upon the terms and conditions under which Kern River would offer such levelized rates, particularly whether the parties considered if shippers must have contracts for service during all, or part, of Period Two.

166. The Commission recognized that the fact firm shippers' contracts for service during Period One have at all times been coterminous with the length of the Period One applicable to each shipper may suggest an underlying assumption, when the Original System was certificated, that firm shippers would also be required to have contracts for the entire length of Period Two. On the other hand, the Commission pointed out that during the optional expedited certificate proceeding Kern River's depreciable life was expected to be only 25 years, so that Period Two would be only 10 years long. However, in this proceeding, we have found that when the extended Period One contracts expire on September 30, 2011 Kern River will still have a remaining depreciable life of over 30 years. Therefore, Period Two will be several times longer than the 10 years anticipated when the optional expedited certificate issued, because of the increase in Kern River's depreciable life. Moreover, the Extended Term Settlement and the 2002 and 2003 Expansions reflected a modification in the original risk sharing agreement to permit shippers to choose between 10 and 15-year contracts during Period One, with the length of Period One depending upon which option was chosen.

²⁰⁷ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 255 (*citing Ozark Gas Transmission System*, 50 FERC ¶ 61,252 (1990) (requiring a pipeline to implement levelized rates to ensure that its shippers received the benefit of its declining rate base). *See also Trailblazer Pipeline Co.*, 50 FERC ¶ 61,188 (1990); *Overthrust Pipeline Co.*, 53 FERC ¶ 61,118 (1990); *Wyoming Interstate Pipeline Co.*, 69 FERC ¶ 61,259 (1994)).

167. Opinion No. 486-C concluded that these changed facts raised the issue of whether it is reasonable to require shippers to enter into contracts for the entire remaining depreciable life of Kern River in order to obtain Period Two levelized rates, particularly if there was no clear intent in the original risk sharing agreement that shippers must have contracts for the entire length of Period Two. The Commission then listed a number of options for resolving the issue of coordinating the length of the shippers' Period Two contracts with the length of the levelization period. These were: (1) requiring shippers to enter into contracts for the entire length of Period Two, if they desire levelized rates for Period Two, (2) offering the shippers one or more options permitting them to enter into contracts of some specified minimum duration but shorter than Kern River's remaining depreciable life, while nevertheless levelizing Kern River's Period Two rates over the entire remaining depreciable life, (3) offering optional contract lengths that are shorter than Kern River's remaining depreciable life as in the previous option, but requiring the rates in those contracts to reflect a Period Two cost of service levelized over the term of the contracts, rather than Kern River's remaining depreciable life, and (4) not requiring any minimum contract duration.

168. Because the hearing conducted by the ALJ in this case only addressed issues concerning Kern River's Period One rates, the Commission found that the present record was inadequate to resolve the issue of whether, and how, the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two rate levelization period. The Commission accordingly set for hearing this issue, as well as other issues concerning what conditions shippers must satisfy in order to be eligible for the levelized Period Two rates or how such levelized rates should be calculated.

Kern River's Rehearing Request

169. On rehearing, Kern River argues that the Commission erred in finding that that rates may be levelized over a period longer than the terms of the shippers' contracts. Kern River concedes that it is correct that the Commission in *Ingleside* and *Southern Trails* did not withhold approval of the pipelines' proposals to charge rates levelized over periods longer than the shippers' contract terms; however, it asserts that the key point is that, in both those cases, the Commission rejected regulatory asset treatment for the deferred costs associated with levelization, because of the lack of contracts commensurate with the proposed levelization period. Kern River argues that the assurance of future recovery of deferred amounts through the establishment of a regulatory asset is a critical element of any levelization plan. Moreover, Kern River argues that there is no practical basis upon which to formulate just and reasonable levelized rates in Period Two without any indication of whether, and for what terms, shippers might contract for Period Two service.

170. Kern River argues that in both *Ingleside* and *Southern Trails*, the pipeline had a choice of whether to negotiate amendments to their contracts or to propose a different rate methodology once the Commission rejected the regulatory asset component of their levelization proposals. Kern River argues that in the instant case neither it nor the Commission has information sufficient to develop just and reasonable, levelized Period Two rates. Kern River argues that the Commission has nonetheless ordered Kern River to file levelized Period Two rates and to bear the risk that the deferred depreciation expense associated with any capacity that is unsold in Period Two will be unrecoverable, because the absence of shipper contracts will preclude Kern River from recording a regulatory asset for the deferred costs. Kern River argues that the Commission has no basis to compel a pipeline to file rates that will preclude the company from a reasonable opportunity to recover a portion of its prudently incurred costs.

Commission Determination

171. The Commission finds that its general discussion of its levelized rate policy with regard to contracts was correct. While Kern River asserts that the assurance of future recovery of deferred amounts through the establishment of a regulatory asset is a critical element of any levelization plan and that this element conflicts with the Commission's requirement that Kern River file levelized rates for Period Two, the Commission points out that in both *Ingleside* and *Southern Trails* the Commission eventually approved the use of a levelized cost of service even though it did not approve of the pipeline's regulatory asset treatment. In any event, as Opinion No. 486-C pointed out and Kern River does not contest, in other cases the Commission has required pipelines to use levelized rates not linked to any specific contract term.²⁰⁸ In those cases, the pipelines had declining rate bases and, because the Commission lacks the authority to order pipelines to make section 4 rate filings, the Commission held that levelized rates were necessary to ensure that the pipeline's rates remained just and reasonable.²⁰⁹

²⁰⁸ *Ozark Gas Transmission System*, 50 FERC ¶ 61,252 (1990) (*Ozark*) (requiring a pipeline to implement levelized rates to ensure that its shippers received the benefit of its declining rate base). *See also Trailblazer Pipeline Co.*, 50 FERC ¶ 61,188 (1990); *Overthrust Pipeline Co.*, 53 FERC ¶ 61,118 (1990); *Wyoming Interstate Pipeline Co.*, 69 FERC ¶ 61,259 (1994). The Commission also permitted regulatory asset treatment in those cases.

²⁰⁹ *See Ozark*, 50 FERC at 61,764-765, where the Commission required levelized rates in response to the court's decision in *Public Service Commission of*

(continued...)

172. In addition, we think it clear from the *WyCal* orders discussed above that the Commission did not view the multi-period levelized rate design approved for *WyCal*, Kern River, and Mojave as necessarily requiring that shippers have contracts coterminous with each of the levelization periods. When the Commission issued the *WyCal* optional expedited certificate orders, the pipeline did not yet have contracts with its shippers, and the Commission pointed out that individual shippers could negotiate as to the length of their contracts. The Commission illustrated this discussion with an example of a shipper offering a 10-year contract, which of course was less than the 15-year term of Period One.²¹⁰

173. While the Commission reaffirms Opinion No. 486-C's holding that Commission policy permits rates to be levelized over a longer period than the terms of the shipper contracts, neither Opinion No. 486-C nor this order make any final decision concerning whether, and how, the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two rate levelization period. Opinion No. 486-C set that issue for hearing. Among other things, the Commission noted that the fact Kern River's shippers' Period One contracts have always been coterminous with the length of the Period One applicable to each shipper may suggest an underlying assumption, when its Original System was certificated, that firm shippers would also be required to have contracts for the entire length of Period Two. And Opinion No. 486-C listed at least four possible options for resolving that issue, some of which would require a shipper's Period Two contracts to match the levelization period underlying the rates to be paid by that shipper. All parties may at the hearing present their positions on whether and how the length of shipper contracts during Period Two should be coordinated with the levelization period underlying their contracts.

e. Other Issues

174. In several places in its rehearing request, Kern River asserts that the Commission has improperly restricted its right under NGA section 4 to propose rate changes at an appropriate time of the company's choosing.²¹¹ It also refers

New York v. FERC, 866 F.2d 487 (D.C. Cir. 1989), reversing the Commission's prior remedy of requiring the pipeline to file section 4 rate cases every three years.

²¹⁰ *WyCal*, 45 FERC at 61,677. The Commission also stated, "If the reservation fee is clearly negotiable, the pipeline is not guaranteed any revenue until the shipper agrees to pay the reservation charge. Therefore, the pipeline is at risk until a shipper agrees to pay an agreed-upon fee." *WyCal*, 44 FERC at 61,007.

²¹¹ Kern River Rehearing Request at 33 n.43.

back to its request for rehearing of Opinion No. 486's requirement that it file Period Two rates.²¹² In that rehearing request, Kern River contended that the Commission lacked authority to order Kern River to file rates to be effective at multiple future dates, asserting that it should have the prerogative to decide whether to implement step-down rates for Period Two through a section 4 filing or by offering customers discounts or negotiated rates when their Period One contracts expire. Kern River argues that Opinion No. 486-C's requirement that the Period Two rates be levelized, without at least permitting the issue to be addressed at the hearing, compounds the Commission's original error.

175. Our actions in this proceeding have not improperly restricted Kern River's rights under NGA section 4. While the NGA gives the pipeline the initiative to propose rate changes under NGA section 4, NGA section 5 also gives the Commission the authority to order prospective rate changes, when the Commission finds the pipeline's existing rates to be unjust and unreasonable. In Opinion Nos. 486 and 486-A, the Commission held that it could not find Kern River's section 4 proposal to continue its levelized rate methodology for the remainder of Period One to be just and reasonable, unless Kern River's tariff also included Period Two rates providing for the return of the excess recovery of depreciation expense built into the Period One rates.²¹³ In addition, any continuation of the Period One rates beyond the term of the shippers' current contracts would be unjust and unreasonable. As is amply clear from the discussion in the preceding sections of this order, those rates have always been designed to apply only during the terms of the shippers' current contracts, at which time Kern River's rates are to be reduced to return the regulatory liability representing the excess depreciation recovery.

176. The only way the Commission can ensure that Kern River's rates are reduced to a just and reasonable level as of the beginning of Period Two was by initiating this section 5 proceeding sufficiently in advance of the end of Period One to enable the Commission to determine just and reasonable Period Two rates before the end of Period One. That is because the Commission lacks refund authority when it acts under NGA section 5. The need to conduct this proceeding well before the end of Period One is confirmed by the fact that there

²¹² *Id.* at 36 n.50.

²¹³ *Citing Western Resources, Inc v. FERC*, 9 F.3d 1568, 1577-79 (D.C. Cir. 1993), in which the court held that an action may originate as a section 4 proceeding only to be transformed later into a section 5 proceeding.

is now less than one year before the end of Period One for the 10-year shippers on Kern River's Original system. Yet the ALJ must still conduct the hearing established by Opinion No. 486-C, now scheduled for December. After the hearing, the ALJ must issue his initial decision and the Commission must issue an order on initial decision.

177. We also reaffirm our decision to resolve the issue whether the Period Two rates must be levelized before the hearing. While Kern River asserts that the Commission should have allowed it to present evidence on this issue at the hearing, it has made no proffer of the evidence it would submit. All Kern River states is that the Commission should have included in the hearing "the factual question of whether there are any agreements between Kern River and its shippers with respect to how Period Two rates are to be determined."²¹⁴ However, as discussed above, our holding that the Period Two rates must be levelized does not rely on any finding that Kern River and shippers entered into any bilateral contracts requiring Kern River to offer levelized rates during Period Two. In the absence of any proffer of evidence by Kern River that there are agreements between it and its customers relevant to the resolution of the levelized rate issue which are not currently in the record, Kern River has not justified inclusion of that factual issue in the hearing.²¹⁵ Nor has Kern River identified any other factual issue relevant to the resolution of this issue that requires a hearing.

178. Finally, nothing in this order is intended to prohibit Kern River from proposing in a future section 4 rate case to shift to a traditional rate design. Kern River would, of course, have the burden under NGA section 4 to show that its proposal was just and reasonable, and in order to meet that burden it would likely have to show some change in circumstance that rendered the holdings in this order no longer applicable.

²¹⁴ Kern River Rehearing Request at 28.

²¹⁵ See *Blumenthal v. FERC*, 613 F.3d 1142 (D.C. Cir. 2010), and cases cited therein).

B. Kern River Period Two Compliance Tariff Filings

1. Background

179. In Opinion No. 486-C, the Commission directed Kern River to file, within 45 days, *pro forma* Period Two tariff sheets, setting forth its proposal for offering firm shippers levelized Period Two rates. The Commission also explicitly set forth the procedure to be taken in regard to Period Two rates as follows:

[W]hile the Commission finds that Kern River must offer levelized rates for Period Two as discussed in the preceding section, the Commission establishes a hearing to consider all other issues concerning the Period Two rates, including the eligibility requirements shippers must satisfy in order to obtain such rates and how the levelized rates should be calculated.²¹⁶

The Commission also stated that, in setting this matter for hearing, it “does not intend that any issues already litigated and decided in this proceeding be re-litigated. Therefore, the Period Two Rates must be calculated consistent with all of the rulings in Opinion Nos. 486, 486-A, 486-B, and 486-C.”²¹⁷

180. Although the Commission set matters related to Period Two rates for a trial-type evidentiary hearing, the Commission stated that the Period Two rate issues “would be best resolved by settlement, because at bottom they are rooted in the parties’ assessment of how the risks should be shared during Period Two, given the current circumstances.”²¹⁸ Therefore, the Commission held the hearing in abeyance and directed a settlement judge to be appointed to facilitate negotiations regarding these matters. The Commission directed that the settlement ALJ, as appointed by the Chief ALJ, report to the Chief ALJ concerning the status of settlement discussions.²¹⁹

181. On February 1, 2010, Kern River filed *pro forma* tariff sheets in Docket No. RP04-274-022, to comply with the directives of Opinion No. 486-C

²¹⁶*Id.* P 263.

²¹⁷ *Id.* P 263, n.302.

²¹⁸*Id.* P 264.

²¹⁹ *Id.* P 265.

concerning proposed Period Two rates. Kern River stated that the components for the derivation of the illustrative Period Two rates stated on its *pro forma* tariff sheets were: (1) a levelization period of ten years; (2) an annual inflation adjustment to Operation and Maintenance (O&M) and Administrative and General (A&G) expenses of 3.3 percent; (3) a regulatory asset adjustment for compressor engines and general plant replacements amortized over the levelization period; (4) a rate of return on equity of 13 percent; (5) billing determinants utilized for cost allocation and rate design equal to 95 percent of design capacity; and (6) a revenue credit adjustment for Period One shippers necessary to reflect the reduced revenue received from 2002 rolled-in shippers as their rates “step down” over time.

182. Public notice of Kern River’s February 1, 2010 filing was issued on February 4, 2010 with comments due on February 16, 2010. Nevada Power Company d/b/a NV Energy, RRI Energy Services, Inc., the Southern California Generation Coalition, Williams Gas Marketing, Inc., BP Energy Company, Calpine Energy Services, LP, Southern California Gas Company, the Rolled-in Customer Group and Southwest Gas Corporation filed comments.

183. In general, these parties protested Kern River’s filing and asserted that Kern River seeks to impose elements in its rate calculations not permitted by the Commission’s orders in this proceeding. Specifically, they argued that Kern River has submitted *pro forma* rates reflecting several components that contradict the Commission’s previous holdings in this proceeding including, but not limited to: (1) an annual inflation adjustment to O&M and A&G expenses of 3.3 percent; (2) a rate of return on equity of 13 percent; and (3) billing determinants for cost allocation and rate design equal to 95 percent of design capacity. The parties argued that these components have been litigated in the instant proceeding and the Commission has made findings on these issues that differ from Kern River’s compliance filing proposals.

184. The parties asserted that the Commission previously rejected Kern River’s proposal to use a 3 percent inflation adjustment for A&G and O&M costs in this rate case.²²⁰ They argued that in Opinion No. 486-B, the Commission established Kern River’s ROE at 11.55 percent.²²¹ The parties also asserted that the Commission rejected Kern River’s use of billing determinants equal to 95 percent

²²⁰ Opinion No. 486, 117 FERC ¶ 61,077 at P 105; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 93.

²²¹ Opinion No. 486-B, 126 FERC ¶ 61,034 at P 153.

of design capacity for cost allocation and rate design in Opinion No. 486.²²² The parties also asserted that Kern River has made other improper rate calculations in its *pro forma* rate filing such as the use of a 10 year levelization period, a 100 percent equity capital structure, and a failure to show that its excess recovery of depreciation in Period One will be returned in Period Two. The Parties requested that the Commission require Kern River to submit a revised filing consistent with the Commission's determinations in this proceeding. Subsequent to filing their protests to Kern River's February 1, 2010 *pro forma* compliance filing, several parties to the instant proceeding filed a motion concerning Kern River's Period Two compliance filing.

2. Motion

185. On March 25, 2010, Nevada Power Company, RRI Energy Services, Inc. and BP Energy Company (collectively, Movants) filed a motion with the Commission requesting the Commission to (1) reject Kern River's February 1, 2010 filing to comply with Opinion No. 486-C regarding Period Two rates; (2) direct Kern River to file a new compliance filing to comply with prior Commission orders; (3) implement a paper hearing to resolve the remaining Period Two issues concurrently with settlement negotiations, or in the alternative institute a hearing schedule; and (4) take other steps to ensure just and reasonable Period Two rates will be in effect for them as of October 1, 2011 when Period Two will commence for them.

186. The Movants again argued that Kern River's February 1, 2010 Period Two rate compliance filing is inconsistent with prior Commission orders for a variety of reasons including its usage of: (1) billing determinants equal to 95 percent of design capacity; (2) a 10-year long Period Two levelization period; (3) a 13 percent return on equity; and (4) an inflation adjustment for O&M and A&G expenses. Moreover, Movants argued that action on the instant compliance filing is important because Kern River now seeks to re-litigate issues that the Commission has already determined in this proceeding. The Movants asserted that those determined issues are not properly reflected in Kern River's compliance filing.

187. Movants stated that they now must face a set of non-compliant tariff sheets that deprive them of the determinations reached in the Commission orders in the instant proceeding. Movants contended that some of the outstanding Period Two

²²² Opinion No. 486, 117 FERC ¶ 61,077 at P 86; Opinion No. 486-C, 129 FERC ¶ 61,240 at P 150.

issues may be resolved by settlement but they also stated that settlement negotiation could not be the exclusive means of resolving outstanding Period Two issues.²²³ On April 2, 2010, Kern River filed an answer opposing this motion.

3. Termination of Settlement Judge Procedures

188. On April 9, 2010 the Chief ALJ, upon recommendation of the Settlement ALJ, terminated settlement procedures in the instant proceeding and appointed a Presiding ALJ to conduct a hearing on these matters pursuant to Time Track III.²²⁴ The parties to this proceeding challenged the use of Time Track III and argued that a Time Track I hearing be instituted.²²⁵ On April 22, 2010, the Presiding ALJ issued an order adopting Track III of the procedural guidelines, and noted that the parties had agreed that the pending motion before the Chief Judge to replace the Track III procedures with Track I procedures would be withdrawn.²²⁶

4. Discussion

189. The Commission denies the March 25, 2010 motion by the Movants to modify the procedures established by Opinion No. 486-C for resolution of Period Two issues. The Commission also denies the motion to reject Kern River's February 1, 2010 compliance filing concerning its Period Two rates. However, the Commission will clarify the issues set for hearing, as discussed below.

²²³ *Id.* p. 9-11.

²²⁴ Order of Chief Judge Terminating Settlement Judge Procedures, Designating Presiding Administrative Law Judge, And Establishing Track III Procedural Time Standards, *Kern River Gas Transmission Co.*, Docket No. RP04-274 (April 9, 2010) (unpublished order).

²²⁵ On April 12, 2010, Nevada Power Company d/b/a NV Energy, RRI Energy Services, Inc., the Southern California Generation Coalition, Williams Gas Marketing, Inc., and BP Energy Company filed a Motion for Reconsideration, Initiation of Track One Procedural Schedule and Shortened Answer Period. They requested that the Chief Judge reconsider the April 9, 2010 Order establishing Track III procedural time standards in this proceeding and instead establish Track I procedural time standards for the hearing concerning Period Two. On April 23, 2010, in light of the procedural schedule set forth by the Presiding ALJ on April 22, 2010, the parties agreed to withdraw their Motion.

²²⁶ *Kern River Gas Transmission Co.*, 131 FERC ¶ 63,006 (2010).

190. Subsequent events have rendered moot the Movants' request that the Commission implement a paper hearing to resolve the remaining Period Two issues concurrently with settlement negotiations, or in the alternative institute a hearing schedule. As set forth above, the Chief ALJ has terminated the settlement judge procedures and appointed a Presiding Judge to conduct a hearing. After considering the arguments similar to those set forth by the Movants here, the Presiding ALJ established a schedule based upon Timing Track III procedures and the parties withdrew their objection to the Chief ALJ's previous determination that those procedures be used. All parties have filed three rounds of testimony, and the hearing is scheduled to commence on December 8, 2010, with an initial decision to issue by April 22, 2010.

191. The Commission also denies the motion to reject Kern River's Period Two compliance filing. Opinion No. 486-C directed Kern River to file, within 45 days, *pro forma* Period Two tariff sheets, setting forth its proposal for offering firm shippers levelized Period Two rates. The Commission required Kern River to make that compliance filing in the form of *pro forma* tariff sheets, because it intended the filing simply as a statement by Kern River of its opening position as to how its Period Two rate should be determined. If Kern River did not fully implement the Commission's rulings in its *pro forma* calculation of Period Two rates, as asserted by the protests to the filing, the parties are free to point such deficiencies out to the Presiding ALJ for proper consideration, and a review of the testimony filed so far indicates the parties have taken full advantage of that opportunity.

192. While the Commission will not reject Kern River's Period Two compliance filing, the Commission will clarify the issues set for hearing in order to assist the parties and the ALJ. When the Commission initially required Kern River to file tariff sheets setting forth its Period Two rates in Opinion Nos. 486 and 486-A, the Commission specified that those rates were to be "based on the instant cost of service" established in this rate case.²²⁷ The Commission did not modify that directive in Opinion No. 486-C, and the Commission specified that it did "not intend that any issues already litigated and decided in this proceeding be re-litigated."²²⁸

²²⁷ Opinion No. 486, 117 FERC ¶ 61,077 at P 54. Opinion No. 486-A, 123 FERC ¶ 61,056 at P 62.

²²⁸ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 263, n.302.

193. The Commission continues to find that the starting point for calculating the Period Two rates in this proceeding must be the cost of service we have already determined for Period One based upon the 2004 test year data used in this section 4 rate case. To do otherwise would effectively turn the Period Two aspect of this proceeding into a limited section 4/5 proceeding developing rates for groups of customers taking service under Period Two contracts based on a different overall cost of service than used for other groups of customers still taking service under Period One contracts. The Commission generally does not permit a pipeline to file a limited section 4 proceeding to change the rates for some services but not others; nor would the Commission ordinarily entertain a section 5 proceeding solely to adjust the rates for some of a pipeline's services without looking at the pipeline's entire cost of service. Such an approach is particularly inappropriate in this case, where 10-year and 15-year shippers taking the identical service using the identical facilities will commence service under Period Two contracts on different dates. For example, it would not be just and reasonable for the 10-year shippers on the Original System to pay rates based on one cost-of-service reflecting at least some updated cost items starting on October 1 of this year, while the 15-year shippers continue to pay rates based on a different cost of service without updates for the following five years.²²⁹

194. The only exception to this general approach to developing Kern River's Period Two rates is where there are circumstances unique to the transition from Period One to Period Two rates that justify an adjustment to the cost of service underlying the Period One rates. These circumstances include, of course, the fact the Period Two rates must return the excess recovery of depreciation expenses existing at the end of Period One. Accordingly, the parties at the hearing may address all issues related to whether the Period Two rates have been appropriately adjusted to return the excess recovery of depreciation projected to occur during Period One based upon the 2004 test period data used to develop Kern River's rates in this rate case.

²²⁹ If Kern River believes that the cost-of-service determined in this section 4 rate case based on 2004 test period data is now stale and should be updated, then it is free to file a new general section 4 rate case at any time to update the cost of service underlying the rates of all its shippers for all its services. Likewise, if any shipper believes that the cost-of-service developed in this rate case should be updated it may file a complaint under NGA section 5 against all of Kern River's rates.

195. The second permitted adjustment to the cost of service underlying the Period One rates is the use of a 100 percent equity structure for the Period Two rates. As previously discussed, the August 1992 Order in the optional expedited certificate proceeding granted Kern River's request for clarification that it will have a 100 percent equity capital structure during Period Two, absent any refinancing of its debt, and no such refinancing occurred during the test period in this rate case.

196. Third, while the August 1992 Order clarified that Kern River's Period Two rates would be designed using a 100 percent equity capital structure, it also stated that the Commission reserved its right to reexamine Kern River's return on equity in light of the change in capital structure.²³⁰ In Opinion Nos. 486-B and 486-C, the Commission held that Kern River's return on equity underlying its Period One rates should be set at the 11.55 percent median of the range of reasonable returns determined in those orders.²³¹ However, Opinion No. 486-C stated that at the hearing on Period Two rates BP could raise the issue of whether Kern River's return on equity in Period Two should be less than the median, because of the reduced risk of a 100 percent equity capital structure.²³² In its Period Two compliance filing, Kern River contends that its return on equity for Period Two should be higher than the median, because the expiration of its Period One contracts increases its risk. Consistent with the August 1992 Order and Opinion No. 486-C, the Commission will permit parties at the hearing to address whether Kern River's return on equity for Period Two should be adjusted from the median 11.55 return on equity underlying its Period One rates. Given that BP and other shippers are permitted to present testimony supporting a return on equity below the median, Kern River is permitted to present testimony supporting an adjustment above the median.

197. However, the Commission clarifies that the parties may not relitigate the issue of the appropriate proxy group, the range of reasonable returns, and the median to be used as the starting point for any adjustment from the median. In Opinion No. 486-B, the Commission determined that Kern River's capital costs in this section 4 rate case should be determined based on the 2004 test year, including proxy company data for that year.²³³ The Commission stated that all

²³⁰ *Kern River*, 60 FERC at 61,437.

²³¹ Opinion No. 486-C, 129 FERC ¶ 61,240 at P 97.

²³² *Id.* P 117.

²³³ Opinion No. 486-B, 126 FERC ¶ 61,034 at P 57.

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. The same reasoning applies here, since we have held that the Period Two rates must be designed based on data from the 2004 test period. It also follows that any testimony supporting any adjustment above or below the median should similarly be based on 2004 test period information.

198. Fourth, the Commission has required Kern River's Period One rates to be designed based on its actual Period One billing determinants. However, as Kern River points out in its compliance filing, its Period One contracts expire at the end of Period One and it does not currently have contracts with any shippers for Period Two. Kern River's Period Two rates must be designed based upon some projection of the billing determinants that will be in effect during Period Two. Accordingly, the parties may address at hearing whether the volumes used to design the Period Two rates and allocate costs should be based upon 95 percent of Kern River's design capacity, a projection that its Period One contracts will be renewed, or some other basis.

199. Fifth, the issue of an inflation adjustment to Kern River's O&M and A&G costs should not be relitigated in the Period Two hearing. In Opinion Nos. 486 and 486-A, the Commission held that such an inflation adjustment is permitted by the rate design principles approved in the optional expedited certificate proceeding, but that Kern River had failed to support any specific inflation factor in this rate case.²³⁴ Therefore, Kern River's Period One rates in this case do not reflect any such inflation adjustment. Kern River's O&M and A&G costs of operating its integrated system do not vary depending upon whether its shippers have Period One or Period Two contracts. Therefore, there is no justification for the rates of Period Two shippers to reflect inflation-adjusted O&M and A&G costs, while the rates of the Period One shippers do not. The Commission did not intend the Period Two hearing as an opportunity for Kern River to cure its failure of proof on this issue in the earlier hearing in this rate case.

200. Finally, the Commission established the hearing concerning Kern River's Period Two rates for the primary purpose of addressing the issue of whether, and how, the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two rate levelization period. Opinion No. 486-C listed a number of possible options for resolving that issue. These were: (1) requiring shippers to enter into contracts for the entire length of Period Two, if they desire levelized rates for Period Two, (2) offering the shippers one or

²³⁴ Opinion No. 486 at P 94-105. Opinion No. 486-A at P 106-122.

more options permitting them to enter into contracts of some specified minimum duration but shorter than Kern River's remaining depreciable life, while nevertheless leveling Kern River's Period Two rates over the entire remaining depreciable life, (3) offering optional contract lengths that are shorter than Kern River's remaining depreciable life as in the previous option, but requiring the rates in those contracts to reflect a Period Two cost of service leveled over the term of the contracts, rather than Kern River's remaining depreciable life, and (4) not requiring any minimum contract duration. Parties are free at the hearing to support or oppose any of these options or to argue for some other option concerning contract duration and the length of the levelization period not listed in Opinion No. 486-C.

201. Similarly, Opinion No. 486-C included in the hearing the issue of what conditions shippers must satisfy in order to be eligible for leveled Period Two contracts, and nothing in this order is intended to restrict the positions parties may take on that issue at the Period Two hearing.

202. In summary, the Period Two rates in this proceeding should be developed based upon the same 2004 test year data used in developing the Period One rates in this section 4 rate case. In general, this should lead to the use of the same cost of service for the Period Two rates as for the Period One rates, except where circumstances unique to the transition from Period One to Period Two rates justify projecting different costs or volumes than used in developing the Period One rates.

The Commission orders:

(A) The requests for rehearing are denied for the reasons stated in this order.

(B) The Period One tariff sheets listed in the Appendix are accepted effective on the dates listed in that appendix, subject to the outcome of Kern River's September 10, 2010 request for clarification and the disposition of its filings in Docket Nos. RP10-1406-000 and RP11-1499-000. Kern River is directed to file these accepted tariff sheets as revised tariff records in eTariff, within 15 days of the date of the issuance of this order.

(C) The March 25, 2010 motion by Nevada Power Company, RRI Energy Services, Inc. and BP Energy Company is denied.

(D) The issues concerning Period Two set for hearing are clarified as discussed above.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

Appendix

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**Kern River Gas Transmission Company
Docket No. RP04-274-016, *et al.*
Second Revised Volume No. 1
Accepted Tariff Sheets**

Effective November 1, 2004

6th Sub Thirteenth Revised Sheet No. 5
7th Sub Ninth Revised Sheet No. 5-A

Effective January 1, 2005

6th Sub Fourteenth Revised Sheet No. 5
7th Sub Tenth Revised Sheet No. 5-A

Effective April 1, 2005

4th Sub 1st Rev 15th Revised Sheet No. 5
4th Sub 1st Rev 11th Rev Sheet No. 5-A

Effective October 1, 2005

4th Sub 1st Rev 16th Revised Sheet No. 5
4th Sub 1st Rev 12th Rev Sheet No. 5-A

Effective April 1, 2006

4th Sub 1st Rev 17th Revised Sheet No. 5
4th Sub 1st Rev 13th Rev Sheet No. 5-A

Effective October 1, 2006

4th Sub 1st Rev 18th Revised Sheet No. 5
4th Sub 1st Rev 14th Rev Sheet No. 5-A

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**Kern River Gas Transmission Company
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Second Revised Volume No. 1
Accepted Tariff Sheets**

Effective April 1, 2007

4th Sub 2nd Rev 18th Revised Sheet No. 5
4th Sub 2nd Rev 14th Rev Sheet No. 5-A

Effective October 1, 2007

4th Sub 3rd Rev 18th Revised Sheet No. 5
4th Sub 3rd Rev 14th Rev Sheet No. 5-A

Effective January 1, 2008

4th Sub 4th Rev 18th Revised Sheet No. 5
4th Sub 4th Rev 14th Rev Sheet No. 5-A

Effective April 1, 2008

4th Sub 5th Rev 18th Revised Sheet No. 5
4th Sub 5th Rev 14th Rev Sheet No. 5-A

Effective October 1, 2008

5th Sub 6th Rev 18th Revised Sheet No. 5
5th Sub 6th Rev 14th Rev Sheet No. 5-A

Effective January 1, 2009

3rd Sub 2nd Rev 19th Revised Sheet No. 5
3rd Sub 2nd Rev 15th Rev Sheet No. 5-A

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**Kern River Gas Transmission Company
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Second Revised Volume No. 1
Accepted Tariff Sheets**

Effective April 1, 2009

2nd Sub 1st Rev 20th Revised Sheet No. 5
2nd Sub 1st Rev 16th Rev Sheet No. 5-A

Effective October 1, 2009

Sub 3rd Rev 20th Revised Sheet No. 5
Sub 3rd Rev 16th Revised Sheet No. 5-A

Effective December 17, 2009

2nd Sub Twenty-First Revised Sheet No. 5
2nd Sub 17th Revised Sheet No. 5-A
2nd Sub Eighteenth Revised Sheet No. 6
2nd Sub Seventh Revised Sheet No. 7
2nd Sub Fifth Revised Sheet No. 8

Effective January 1, 2010

Twenty-Second Revised Sheet No. 5
Eighteenth Revised Sheet No. 5-A