136 FERC ¶ 61,045
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. RP04-274-023

OPINION NO. 486-E

ORDER ON INITIAL DECISION

(Issued July 21, 2011)

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Paragraph Numbers

1. This order addresses an initial decision issued April 14, 2011[1] in the captioned dockets after the hearing established by Opinion No. 486-C.[2] The Commission established that hearing in order to consider issues concerning the step-down rates Kern River's firm shippers will be entitled to when their current contracts expire. On review, the Commission affirms the ID on all matters, with the exception of its approval of Kern River's proposal to require all shippers contracting for Period Two service to do so under Rate Schedule KRF-1.

I. Background

2. 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. 486.[3] 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 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.[4] 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

[1] *Kern River Gas Transmission Co.*, Opinion No. 486, 117 FERC ¶ 61,077 (2006), *order on reh'g*, Opinion No. 486-A, 123 FERC ¶ 61,056 (2008), *order on reh'g*, Opinion No. 486-B, 126 FERC ¶ 61,034, *order on reh'g*, Opinion No. 486-C, 129 FERC ¶ 61,240 (2009), Opinion No. 486-D, 133 FERC ¶ 61,162 (2010), 135 FERC ¶ 63,003 (2011) (ID).

[2] *See* Opinion No. 486-C, 129 FERC ¶ 61,240 at P 2, 264-265.

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

[4] *See* Original Certificate Order, 50 FERC at 61,144.

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*."[5]

3. In May 2000, Kern River proposed to lower its rates by refinancing its debt and providing for longer debt recovery periods by extending the terms of its firm contracts. The Commission accepted a settlement containing this proposal (the Extended Term (ET) Settlement).[6] 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.[7]

4. In May 2002, Kern River completed an expansion project by adding additional compression to its system (2002 Expansion).[8] 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).[9] 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,

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[5] *Kern River Gas Transmission Co.*, 58 FERC ¶ 61,073, at 61,244 n.38 (1992) (January 1992 Amended Original Certificate Order), *order on reh'g*, 60 FERC ¶ 61,123 (1992) (August 1992 Order) (emphasis added).

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

[7] *Id.* 61,059.

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

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

there were six groups of levelized rate contracts, and the shippers under all those contracts are still paying Period One rates.[10]

5. 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 to continue to design its rates based on the levelized rate design methodology approved in Original Certificate Order, as modified in subsequent proceedings.[11] Because Kern River's firm contracts expire on seven different dates, in its April 30, 2004 rate case filing, Kern River proposed different levelized Period One rates for each of the seven groups of contracts. While the rates approved in the original 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.

6. BP and Trial Staff opposed the Kern River's proposal to continue its levelized rate methodology. 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

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[10] 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.

[11] *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.

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. Most other aspects of Kern River's rate filing were also opposed.

7. Since the original hearing in this rate case, the Commission has issued five orders on Kern River's proposed rates, starting with Opinion No. 486 in October 2006.[12] Opinion No. 486 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.[13] 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, Opinion No. 486 ordered Kern River to include in its tariff the expected Period Two rates that would take effect when the existing contracts expired. In Opinion No. 486-A, the Commission explained that because as of the end of Period One, Kern River will have an excess recovery of its depreciation expense, the Commission could 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.[14]

8. In Opinion No. 486 and the subsequent four orders in the Opinion No. 486 series, the Commission has finally resolved all issues concerning Kern River's

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[12] Opinion No. 486, 117 FERC ¶ 61,077 (2006), *order on reh'g*, Opinion No. 486-A., 123 FERC ¶ 61,056, *order on reh'g*, Opinion No. 486-B, 126 FERC ¶ 61,034, *order on reh'g*, Opinion No. 486-C, 129 FERC ¶ 61,240, Opinion No. 486-D, 133 FERC ¶ 61,162.

[13] Opinion No. 486, 117 FERC ¶ 61,077 at P 37.

[14] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 61 (citing *Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1577-79, 304 U.S. App. D.C. 9 (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)).

Period One rates, and Kern River has paid the refunds required because the Commission required Kern River to reduce the rates that it originally filed for Period One. Among other things, the Commission held that Kern River's Period One rates should be designed based on its actual test period billing determinants and that its return on equity for Period One should be 11.55 percent.[15] However, while the Commission has determined general parameters concerning the design of the Period Two rates, the Commission has not yet established the Period Two rates.

9. In its March 2, 2009 filing to comply with the Commission's requirement that it establish Period Two rates, Kern River proposed to use a traditional rate design for its Period Two rates, rather than continue using the levelized 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.[16]

10. However, Opinion No. 486-C 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.[17] 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

[15] Opinion No. 486-B, 126 FERC ¶ 61,240 at P 23-28, 154-166.

[16] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 253.

[17] *Id.* P 247.

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.[18]

11. Opinion No. 486-C concluded 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.[19] The Commission also suspended the hearing for settlement judge procedures.

12. 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 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 included: (1) a levelization period of ten years; (2) a regulatory asset adjustment for compressor engines and general plant replacements amortized over the levelization period; (3) a rate of return on equity of 13 percent; and (4) billing determinants utilized for cost allocation and rate design equal to 95 percent of design capacity. Numerous protests and comments were filed by the Shipper Parties.[20] They asserted that Kern River sought to impose elements in its rate calculations rejected by the Commission's earlier orders in this proceeding.[21]

13. The parties were unable to reach a settlement of the Period Two issues, and accordingly the Chief ALJ terminated the settlement judge procedures. The

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[18] *Id.*

[19] *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.

[20] The Shipper Parties include Nevada Power Co. d/b/a NV Energy (Nevada Power), RRI Energy Services, Inc., the Southern California Generation Coalition, Williams Gas Marketing, Inc., BP Energy Company (BP), Calpine Energy Services, LP (Calpine), Morgan Stanley Capital Group Inc. (Morgan Stanley), Southern California Gas Co. (SoCalGas), the Rolled-in Customer Group (RCG), and Southwest Gas Corp.

[21] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 183-184.

Presiding ALJ established a hearing schedule based upon Timing Track III procedures. All parties filed three rounds of testimony and the hearing commenced on December 8, 2010.[22]

14. In November 2010, before the hearing, the Commission issued Opinion No. 486-D. Opinion No. 486-D denied Kern River's request for rehearing of Opinion No. 486-C's holding that its Period Two rates be levelized,[23] but the Commission continued to hold that the relationship between any such levelized rates and the contract terms for the Period Two contracts should be addressed at the hearing.[24] Opinion No. 486-D also reiterated the Opinion No. 486-C list of possible options for resolving that issue. The Commission stated that the parties were 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.

15. Opinion No. 486-D also clarified the issues set for hearing in order to assist the parties and the ALJ.[25] The Commission noted that 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.[26] Opinion No. 486-D noted that the Commission did not modify that directive in Opinion No. 486-C, and the Commission had specified there that it did "not intend that any issues already litigated and decided in this proceeding be re-litigated."[27]

16. Opinion No. 486-D again held that the starting point for calculating the Period Two rates in this proceeding must be the cost of service 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

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[22] *Id*. 190.

[23] *Id*. P 160-162, 176-177.

[24] *Id*. P 165, 171-173.

[25] *Id*. P 192.

[26] Opinion No. 486, 117 FERC ¶ 61,077 at P 54; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 62.

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

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. Opinion No. 486-D reiterated that 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.[28] Opinion No. 486-D thus held that 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. Thus 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.[29]

17. Opinion No. 486-D held that 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, that 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 were permitted to 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.[30]

18. Opinion No. 486-D also held that a 100 percent equity structure would be permitted for the Period Two rates. As previously discussed, the August 1992

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[28] *Id*. P 193.

[29] *Id.* Thus 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.

[30] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 194.

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.[31]

19. Opinion No. 486-D further stated that 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 this change in its capital structure.[32] 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.[33] 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.[34] In its Period Two compliance filing, Kern River contended 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 permitted 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 were permitted to present testimony supporting a return on equity below the median, Kern River was permitted to present testimony supporting an adjustment above the median.[35]

20. However, Opinion No. 486-D clarified 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,

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[31] *Id.* P 195.

[32] August 1992 Order, 60 FERC at 61,437.

[33] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 97.

[34] *Id.* P 117.

[35] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 197.

including proxy company data for that year.[36] The Commission therefore stated that all other aspects of Kern River's rates are being established based on data from that time frame, and therefore Kern River's rates should also reflect its capital costs at that time. The same reasoning applies here, since the Commission had 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.[37]

21. Opinion No. 486-D also stated 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 pointed 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 were permitted to 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.[38]

22. The ALJ's principal findings in his ID concerning the issue of how the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two rate levelization period and the eligibility requirements for Period Two contracts were: (1) the term of the Period Two contracts will be 10 or 15 years at the shipper's election;[39] (2) the entire remaining balance of Kern River's original rate base will be levelized during the term of those contracts;[40] (3) Kern River's proposed one year notice by a Period One shipper for continued Period Two service was reasonable;[41] (4) that the shipper must contract for its maximum daily quantity it desires at the beginning of Period

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[36] Opinion No. 486-B, 126 FERC ¶ 61,034 at P 57.

[37] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 197.

[38] *Id.* P 198.

[39] ID, 135 FERC ¶ 63,003 at P 1037-1051.

[40] *Id.* P 998-1015.

[41] *Id.* P 1061, 1074, 1087-1092.

Two;[42] and (5) that the maximum allowed was the current MDQ of the shipper's existing Period One contract.[43]

23. The ID's principal findings on cost of service and rate design issues were that: (1) Kern River had not justified the inclusion of the long term replacement costs of certain compressors in its Period Two levelized rate calculations;[44] (2) the Period Two rates should be designed on a 100 percent load factor;[45] (3) that the equity rate structure for Period Two should be 100 percent;[46] (4) any debt issues raised with regard to Period Two were moot;[47] (5) Kern River had not justified a higher rate of return on equity than the 11.55 percent adopted by Opinion No. 486-C;[48] and (6) the Shipper Parties and the Commission Trial Staff had not justified a lower ROE than 11.55 percent.[49]

24. All of Kern River's firm shippers are still paying Period One Rates. However, the initial contracts of the 10-year shippers for service on the Original system expire on September 30, 2011. Therefore, Period Two for those shippers commences on October 1, 2011.

II. <u>Overview of the Commission's Rulings in this Order</u>

25. In this order, the Commission generally affirms the ALJ's initial decision. In the first section below, the Commission clarifies its burden of proof in this NGA section 5 proceeding. The Commission then addresses issues concerning the eligibility requirements for obtaining service during Period Two. The Commission finds that Kern River may require Period One shippers to enter into

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[42] *Id.* P1083-1086.

[43] *Id.* P 1083-1086.

[44] *Id.* P 1112, 1120-1160.

[45] *Id.* P 1027-1036.

[46] *Id.* P 331, 1110.

[47] *Id.* P 336, 1110.

[48] *Id*. P 1016-1026.

[49] *Id*.

Period Two contracts with terms of either 10 or 15 years at the shipper's election and that the entire remaining balance of Kern River's original capital investments may be levelized during the term of those contracts. The Commission clarifies that, when those Period Two contracts expire, the shippers will be eligible for reduced Period Three rates. The Commission affirms the ALJ's approval of Kern River's other proposed eligibility requirements, with the exception of his holding that Kern River may require shippers to take service under Rate Schedule KRF-1, instead of the other open access firm transportation rate schedules under which they are currently taking service. This finding is without prejudice to Kern River filing under NGA section 4 to propose elimination of its other firm service rate schedules in a not unduly discriminatory manner.

26. In the balance of this order, the Commission affirms the ALJ's findings concerning the cost of service and billing determinants to be used in calculating Kern River's Period Two rates. The Commission directs Kern River to file revised tariff records including both the Period Two rates and the eligibility requirements for those rates on or before August 5, 2011. Those tariff records setting forth the Period Two rates shall have an October 1, 2011 effective date and the tariff records setting forth the eligibility requirements shall have a September 1, 2011 effective date.

III. NGA Section 5 Burdens

27. As the Commission reiterated in Opinion No. 486-D,[50] the Commission is acting under NGA section 5 in requiring Kern River to include Period Two rates in its tariff. 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.[51] The Commission must demonstrate: (1) that the existing rate or practice is unjust and unreasonable; and that the alternative rate or practice is just and reasonable. In the earlier proceedings in this case, the Commission has already found, consistent with the first prong of its section 5 burden, that Kern River's failure to include Period Two rates in its tariff is unjust and reasonable. The purpose of the hearing established by Opinion No. 486-C was to develop a record for the purpose of establishing just and reasonable Period Two rates, consistent with the second prong of the Commission's burden.

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[50] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 109-110.

[51] BP Brief on Ex. at 8 (citing ID, 135 FERC ¶ 63,003 at P 997).

28. Consistent with Opinion No. 486-D, the ALJ held that the present phase of the instant proceeding was initiated by the Commission under NGA section 5.[52] Given this finding, the ALJ held that, "the Commission (through Trial Staff and the Shipper parties) bear[s] the burden of producing the evidence necessary to establish just and reasonable rates for Kern River Period Two service." Further the ALJ held that its findings are therefore "governed by the fact that Kern River does not bear the burden of proof in this proceeding."[53]

Briefs on and Opposing Exceptions

29. BP asserts that the ALJ failed to properly apply the appropriate standards for determining just and reasonable rates pursuant to section 5 of the NGA.[54] BP asserts that, by finding that Kern River does not bear the burden of proof in this proceeding, the ID incorrectly attributed to Kern River's proposed remedy concerning its Period Two rates a presumption of validity. BP argues that the Commission bears the burden of demonstrating that the remedy it adopts in a NGA section 5 proceeding is just and reasonable, regardless of whether the remedy, here the Period Two rates to be included in Kern River's tariff, is proposed by Trial Staff, an intervenor or Kern River, or is simply adopted sua sponte. BP also asserts that the ID incorrectly suggests that there is a legal basis for affording Kern River's proposals in this proceeding deference or a presumption of validity. BP states that, because this proceeding is being conducted pursuant to the Commission's authority under section 5 of the NGA, not NGA section 4, therefore, Kern River is not entitled to the deference afforded an applicant under section 4.

30. Nevada Power also asserts that the ID evaluated the proposals, evidence and arguments of the parties as if this was a proceeding under section 4 of the NGA not section 5 where there is no such burden. Nevada Power argues that the ID effectively imposed on the parties the "burden of proof" obligation applicable to section 4 proceedings that requires that the pipeline's unchanged tariff be shown to

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[52] ID, 135 FERC ¶ 63,003 at P 996 (citing 15 U.S.C. § 717d; Opinion 486-D, 133 FERC ¶ 61,162 at P 174-176 (reiterating this proceeding is pursuant to section 5 of the NGA)).

[53] ID, 135 FERC ¶ 63,003 at P 997.

[54] BP Brief on Ex. at 8 citing ID, 135 FERC ¶ 63,003 at P 997.

be unjust and unreasonable before the Commission may order into effect any competing proposals.[55]

31. Nevada Power argues that the ID appears to have approached the hearing as if it was being conducted as a section 4 proceeding to examine the lawfulness of existing rates because when any concerns arose regarding the evidence submitted by Commission staff or by the parties, the ID resorted to proposals advanced by the pipeline as if they were in effect and should remain undisturbed.[56] Nevada Power asserts that this is simple error because "there is no regulatory or judicial support, and none was cited, for effectively adopting the pipeline's proposals in a section 5 proceeding over those presented by staff and the parties simply because they were supported by the pipeline."[57]

32. Nevada Power asserts that the ID treated the pipeline's *pro forma* tariff sheets as if they were the *status quo* and failed to adequately critique those proposals and to support its resort to them other than to effectively say that Kern River's proposals were to be preferred unless the parties carried a burden to prove they were unjust and unreasonable. Nevada Power argues that the ID failed to apply the proper test which was whether complainants had presented a *prima facie* case and, if so, to thereafter determine whether Kern River had made an affirmative defense of its proposals.[58] Nevada Power argues that complainants

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[55] *See* Nevada Power Brief on Ex. at 16 (citing *Delmarva Power and Light Co*., 25 FERC ¶ 61,022, at 61,124 (1983) (Complainants have no "burden of proof" to demonstrate the illegality of any tariff provision that has never been proposed before by the pipeline or approved by the Commission)).

[56] For example, Nevada Power asserts that the ID stated, "The undersigned agrees with Kern River that no participant offered sufficient testimony to contest whether Kern River's illustrative rates are calculated to return in Period Two the entire regulatory liability accrued during Period One." Nevada Power Brief on Ex. at 16-17 (citing ID 135 FERC ¶ 63,003 at P 1003). Further, Nevada Power states that ID stated "the undersigned sees no valid reason why the method used by Kern River should not be accepted, especially when considering that Kern River does not bear the burden of proof." *Id*. P 1012.

[57] Nevada Power Brief on Ex. at 14.

[58] Nevada Power Brief on Exception at 17 (citing *Public Service Co. of New Hampshire*, 6 FERC ¶ 61,299, 61,710-11 (1979)).

have the burden of coming forth with proof, but not the ultimate burden of persuasion.[59]

33. Nevada Power argues that once the Commission determined that Kern River's existing rates were unlawful its remaining task was to determine the just and reasonable prospective rates. Nevada Power asserts that all of the decisions made in the ID must be supported by evidence and if there is any defect in any participant's proposals that does not justify defaulting to the proposals advanced by the pipeline. Nevada Power argues that the pipeline's proposals carry no more weight than any others and must be subjected to equal scrutiny as those advanced by the staff and the other parties. [60]

34. RCG argues that the ID's finding that Kern River has no burden of proof in the instant NGA section 5 proceeding overlooks the fact that even in a section 5 case, the pipeline has the burden to show that its proposed new rate design is just and reasonable.[61] RCG asserts that the law is clear that even in a section 5 case that where a pipeline "seeks to modify its existing rate design" which RCG argues that Kern River is attempting to accomplish by foreshortening the availability of Period Two rates and presumably eliminating Period Three, the pipeline would still "have the burden to show that its proposed new rate design is just and reasonable."[62] Therefore, the RCG asserts that the ID is in error in concluding that Kern River bears no burden in this case.

35. In its Brief Opposing Exceptions, Kern River argues that the ID correctly recognized that the Commission initiated this proceeding under section 5 of the NGA and properly attributes to the Commission and its proxies for this purpose, the Commission's staff and the shippers, the burden of producing the evidence to establish just and reasonable rates for Kern River's Period Two service, and the burden of persuasion that the Period Two rates so advocated are just and reasonable.

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[59] *Id.* (citing *Minnesota Power & Light Co.*, 23 FERC ¶ 61,393 (1983)).

[60] Nevada Power Brief on Ex. at 15.

[61] RCG Brief on Ex at 9 (citing *Ozark Gas Transmission, L.L.C*, 134 FERC ¶ 61,193, at P 32 (2011)) (*Ozark*).

[62] RCG Brief on Ex. at 16 (citing *Ozark*, 134 FERC ¶ 61,193 at P 32).

36. Kern River argues that BP's suggestion that because the Commission is the ultimate decision maker, Staff and shippers do not bear the burden of proof in this section 5 proceeding is in direct contravention of the law and Commission precedent.[63] Kern River argues that both the Commission's staff and shippers submitted proposed Period Two rates and both, therefore, bore the burden to establish that the rates they sought are just and reasonable. Kern River argues that the Commission should therefore affirm the ID's rulings on the burden of proof.

37. Kern River also argues that any assertion that the ID erroneously imposed a higher burden of proof on shippers regarding their proposals for Period Two rates and gave Kern River's proposals a presumption of validity is in error. Kern River points out that under Commission precedent, in the remedy phase of a section 5 proceeding, a presumption in favor of a pipeline's proposal is acceptable.[64]

Commission Determination

38. When the Commission has found that a pipeline's existing rates or practices are unjust and unreasonable as in this case, the Commission then has the burden of showing that its chosen remedy is just and reasonable.[65] Therefore, we have the burden of demonstrating that the Period Two rates that we require in this order are just and reasonable. In order to satisfy that burden, we may rely on any evidence in the record, regardless of the source of that evidence.[66] In this case, Kern River

[63] Kern River Brief op. Ex. at 10-11 (citing *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 183-84 (D.C. Cir. 1986)) (*Sea Robin*); *Ozark* 134 FERC ¶ 61,192 at P 32.

[64] Kern River Brief op. Ex. at 11-12 (citing *AES Ocean Express LLC v. Fla. Gas Transmission Co.*, Opinion No. 495, 119 FERC ¶ 61,075, *order on reh'g*, Opinion No. 495-A, 121 FERC ¶ 61,267 (2007) (*AES v. Florida Gas*); *see also ANR Pipeline Co.*, 109 FERC ¶ 61,138, at P 28 (2004), *order on reh'g*, 111 FERC ¶ 61,113, at P 19 (2005)).

[65] *See, e.g., Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1578 (D.C. Cir. 1993); *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).

[66] *See Consolidated Edison Co. of New York v. FERC*, 165 F.3d 992, 1008 (D.C. Cir. 1999), and *Ozark Gas Transmission, L.L.C.*, 133 FERC ¶ 61,158, at P 30 (2011).

and its shippers have submitted various competing proposals concerning the just and reasonable Period Two rates that we should adopt pursuant to NGA section 5. Kern River, like any other party proposing a remedy in a section 5 proceeding, must produce sufficient evidence in support of its proposed remedy, to enable us to satisfy our section 5 burden of demonstrating that the remedy it desires us to adopt is just and reasonable. Absent such evidence, we would be unable to satisfy our obligations under section 5, and therefore we could not adopt Kern River's proposed remedy.

39. However, if we are satisfied that Kern River's proposed remedy is just and reasonable, we will adopt that remedy in preference to other just and reasonable remedies that may have been proposed by other parties. For example, in *ANR Pipeline Company*,[67] the Commission stated that, while it was acting under section 5, the Commission:

> also takes into account the fact that the NGA delegates to the pipeline the primary initiative to propose the rates, terms, and conditions for its services under NGA section 4. If the rates, terms, and conditions proposed by the pipeline are just and reasonable, the Commission must accept them, regardless of whether other rates, terms and conditions may be just and reasonable. Consistent with this structure of the NGA, the Commission believes it appropriate in this case, where ANR agrees that its current tariff is unjust and unreasonable, to give ANR a similar initiative in proposing remedial tariff provisions. To the extent ANR's proposed remedy is just and reasonable, the Commission will approve that remedy, even though other just and reasonable remedies might exist.[68]

[67] *ANR Pipeline Co.*, 109 FERC ¶ 61,138 at P 28 , *order on reh'g*,110 FERC ¶ 61,069 at P 49, *order on reh'g*, 111 FERC ¶ 61,113, at P 19 (2005) (ANR).

[68] *Id.* at P 28 (citing *Consolidated Edison Co. v. FERC*, 165 F.3d 992, 998, 1002-04 (D.C. Cir. 1999)). *See also, e.g.*, *PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,331 at P 85 (2006) ("[W]hen choosing between competing just and reasonable options, the Commission has previously stated that it will accept the proposal of a utility if it is just and reasonable, rather than other competing just and reasonable proposals, even in the context of a filing under section 5 of the Natural Gas Act").

40. Given this precedent, it is clear that the Commission has the ultimate burden in the remedy phase of a NGA section 5 proceeding to establish that the rates to be implemented prospectively are just and reasonable. In order to establish such a rate the Commission may rely on any evidence in the record to satisfy its burden.

41. Parties excepting to the ID assert that a pipeline's proposal in the remedy phase of a NGA section 5 proceeding carries no more weight than any others and must be subjected to equal scrutiny as those advanced by the staff and the other parties and that there is no legal basis for affording Kern River's proposals in this proceeding deference or a presumption of validity are at best advancing arguments only partially true. If a pipeline's proposed remedy in a NGA section 5 proceeding is found to be just and reasonable, it is clear, given the holdings in the cases cited above, that the Commission will accept that just and reasonable proposal even in the presence of just and reasonable submissions by other parties to the proceeding. To this extent precedent reveals that the pipeline's proposal is granted a preference.

42. Given that the Commission may rely on the entire record in order to establish a just and reasonable rate and that the Commission will accept a pipeline's proposed remedy if it is found to be just and reasonable, pipelines often propose their own remedy to the proceeding, as Kern River does here. To the extent that Kern River must support its proposal to enable the Commission to find it just and reasonable, Kern River has a burden. However, it is clear that the Commission has the ultimate burden in a section 5 proceeding of establishing a just and reasonable rate to be implemented in the proceeding.

IV. Levelization Period and Contract Duration

43. In Opinion Nos. 486-C and 486-D, the Commission held that Kern River's Period Two rates must be levelized. However, the Commission set for hearing 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 also set for hearing the issue of what conditions the shipper must satisfy in order to be eligible for the levelized Period Two rates.

44. At the hearing, Kern River proposed that Period One shippers be required to enter into either 10 or 15-year contracts for service during Period Two. Kern River proposed that its Period Two levelized rates should be designed to recover the entire 30 percent of its invested capital remaining at the end of Period One over the 10 or 15-year terms of those contracts. Given the interrelated nature of Kern River's contract duration and levelization period proposals, those two

proposals will be discussed together in this section of this order. Kern River's other proposed eligibility conditions for Period Two rates will be discussed in the following section of this order.

45. Kern River's shippers protested its proposed levelization period, contending that the Period Two levelized rates should be designed to recover the remaining 30 percent of Kern River's invested capital over its remaining depreciable life, which the Commission held in Opinion No. 486 would continue until October 31, 2039. Thus, the Period Two rates of 10-year shippers on the Original System would be levelized over a 28-year period extending from October 1, 2011 through October 31, 2039. The Period Two rates of shippers whose contracts expire at later dates would be levelized over correspondingly shorter periods, all ending on October 31, 2039. The shippers also contended that Period One shippers desiring to continue to take service during Period Two should not be required to enter into contracts for the entire levelization period. However, the shippers generally agreed that a minimum contract term of 10 years would be reasonable, with some arguing that shippers should be given the option of entering into 10 or 15-year contracts and others arguing for a series of 10-year contracts.

Initial Decision

46. The ALJ adopted Kern River's proposal. He held that 10-year (and 15-year) levelization period terms are appropriate for Period Two and that the levelization period should be coordinated with the contracts for Period Two.[69] The ID noted Kern River's argument that in Opinion No. 486-C, the Commission set for hearing the question of coordinating the duration of contracts for Period Two service and the levelization period for calculating Period Two rates,[70] and identified four options for the coordination of contract length with the Term of Period Two as set forth in the above background.[71] The ID also noted that the Commission specifically reiterated in Opinion No. 486-D, that the issue of whether and how to coordinate levelized rates with contract terms was to be determined in this proceeding.[72]

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[69] ID, 135 FERC ¶ 63,003 at P 1037.

[70] *Id.* (citing Opinion No. 486-C at P 247; KR IB at 22-26).

[71] *Id.* P 260.

[72] ID, 135 FERC ¶ 63,003 at P 1039 (citing Opinion No. 486-D at P 200).

47. The ID found that the Kern River Shipper contracts have always matched the levelization period on which their rates are based.[73] The ID noted that all contracts on Kern River's Original System were for a term of 15 years, and that this was consistent with the levelization of the cost of service over a 15-year period. Further, the ID finds that "the extended term settlement (ET Settlement) and each expansion of Kern River's system produced new contracts and, in every instance, the terms of these contracts directly corresponded to the levelization period for the affected groups of Shippers."[74]

48. The ID reasoned that a levelization period that matches the term of the Period Two contracts is required in order to maintain the balance embodied in the original levelization package. The ID stated that the Original Certificate order that initially approved levelized rates recognized that shippers' service agreements were synchronized with their respective levelization periods and that because of this, shippers on Kern River's system have understood from the outset the importance of corresponding contract and levelization periods.[75] The ID continued to state that "[N]othing in subsequent Commission orders, including approvals of the ET Settlement and 2002 and 2003 Expansions, suggested that the long-standing link between levelization period and contract term should be disturbed."[76] The ID concluded that Kern River had persuasively argued that its Shippers' contracts have always matched the levelization period on which their rates are based.[77]

49. Moreover, the ID found that decoupling the contract terms from the levelization period imposes an unreasonable risk on Kern River and that any approach which allows Period Two contracts to have duration less than the Period

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[73] ID, 135 FERC ¶ 63,003 at P 1040 (citing Opinion No. 486-C at P 258).

[74] ID, 135 FERC ¶ 63,003 (citing Opinion No. 486, 117 FERC ¶ 61,077 at PP 9-10, 14, 16-17, 20-21).

[75] ID, 135 FERC ¶ 63,003 at P1041 (citing Original Certificate Order , 50 FERC ¶ 61,069 at 61,150; January 1992 Amended Original Certificate Order., 58 FERC ¶ 61,073 at 61,242-44, *order on reh'g*, 60 FERC ¶ 61,123, at 61,437 (1992)).

[76] *Id*.

[77] ID, 135 FERC ¶ 63,003 at P 1047 (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at P 258).

Two levelization period, is contrary to the risk-sharing arrangement memorialized in the Original Certificate Order. The ID found that the 10-year levelization period (or 15-year if applicable) is consistent with the Commission's requirement that Period Two rates be levelized. The Commission has stated that its orders issuing certificates to Kern River and others in 1989-1990 are the foundation for requiring levelization, unless some other treatment is later justified.[78] Kern River's Original Certificate Order contemplated that Period Two would be 10 years long.[79] Therefore, the ID found that Kern River's 10-year levelization period is directly linked to the approach approved by the Original Certificate Order.[80] Accordingly, the ID held that the Period Two levelization period and contract term should be the same and the approach taken by Kern River, to include both 10- and 15-year terms is adopted.[81]

Briefs on and Opposing Exceptions

50. BP argues that these holdings are improper. BP states the Commission has previously rejected both the ID's conclusions on these issues, finding that (i) that Kern River's Period Two rates are to be levelized over Kern River's remaining depreciable life and (ii) Period Two contracts need not be of the same duration as the associated levelization period.

51. BP argues that in Kern River's Original Certificate Order, the Commission approved Kern River's proposal to depreciate its facilities over a 25-year period. In addition, the Original Certificate Order authorized Kern River "to charge one rate for its first 15 years of service [Period One], another rate for years 16 through 25 [Period Two], and a third rate for service rendered after 25 years [Period Three]"[82] BP states that the ID's reliance on this statement in concluding that the

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[78] ID, 135 FERC ¶ 63,003 at P 1050 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 142).

[79] *Id*. (citing Original Certificate Order, 50 FERC ¶ 61,069, at 61,150; January 1992 Amended Original Certificate Order, 58 FERC ¶ 61,073 at 61,242-44, *order on reh'g*, 60 FERC ¶ 61,123, at 61,437 (1992)).

[80] *Id*. (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 120-137).

[81] *Id*.

[82] BP Brief on Ex. at p.19 (citing Original Certificate Order at 50 FERC 61,150).

duration of Period Two should be 10 years is a mistake because subsequent Commission determinations show that Kern River's Period Two rates are to be levelized over Kern River's remaining depreciable life.[83] RCG also argues that the ID's findings are inconsistent with the rate design approved in the Original Certificate Order, which required the Period Two levelization period to be coterminous with the duration of Period Two. RCG argues that the Original Certificate order was premised on the principle that Period Two would last throughout the remaining depreciable life of the pipeline, which in the instant case would be 2039, and Period Three would start thereafter. The RCG states that ID is silent concerning what happens at the end of the 10 or 15-year period at issue and RCG is concerned that absent further action by the Commission, the rate may escalate to the maximum recourse rate in the tariff (which is currently the Period One 10-year 2003 expansion rate). Moreover, RCG states that there is no recognition in the ID of whether and/or when eligible shippers would qualify for Period Three rates.[84]

52. BP and Nevada Power argue that the Commission has repeatedly held that "the levelized rates approved in Kern River's certificate include separate, levelized rates for three different periods," one of which is Period Two, i.e., "the period from the expiration of [Period One] contracts to the end of Kern River's depreciable life . . . ."[85] Therefore, BP argues that it is error to determine that a

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[83] BP Brief on Ex. at p. 20 (citing Original Certificate Order 50 FERC at 61,244 n.38; Opinion No. 486, 117 FERC ¶ 61,077 at P 19).

[84] The RCG supports a methodology in lieu of Kern River's proposal, under which Period Two contracts would be for successive 10-year terms, throughout the duration of Period Two for each shipper class (with the final contract terms being adjusted to match the end date of 2039). Each 10-year contract would recover the portion of 30 percent depreciation expense represented by the total term (e.g., if Period Two is 28 years, 10/28 of the 30 percent depreciation expense would be recovered in the first 10-year contract, etc.), on a levelized basis within each 10-year contract. The RCG argues that this methodology is consistent with the structure and intent of the Original Certificate Order. RCG Brief on Ex. at 20-22. Calpine supports this methodology as well. Calpine Brief on Ex. at 20.

[85] BP Brief on Ex. at p. 20 (citing Opinion No. 486 117 FERC ¶ 61,077 at P 19; Original Certificate Order at 61,244 n.38 (1992) ("Kern River's rates are based on two levelization calculations, one for the first fifteen years and other for the [pipeline's remaining depreciable life]")). Calpine adds that Opinion Nos. 486 through 486-D confirm that Period Two levelization runs from the end of a

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time period of 10 or 15 years is appropriate for Period Two, rather than to conclude that Period Two time period should extend for Kern River's entire remaining depreciable life. As RCG points out, while it is true as the ID asserts that the levelization period has always been consistent with the contract term, the ID misses the point that the levelization period for Period Two was designed to last through the duration of Period Two. Morgan Stanley adds that the fact that shippers' contracts have always matched the levelization period on which their rates are based is insufficient to justify mandating the synchronization of the levelization periods and contract terms after the Commission extended Period Two to 2039 because the Commission previously rejected the assertion that Period Two contracts must be the same length as the levelization period in its earlier orders in this case.[86]

53. Moreover, BP argues that if the Commission intended for Kern River's system to be fully depreciated at the end of a 10-year Period Two, there would have been no need for the Commission to determine the remaining useful life of Kern River's system.

54. BP argues that limiting Period Two to a 10 or15-year period is also inconsistent with Kern River's representations in the ET proceeding where Kern River's shippers entered into new, extended term contracts and were permitted to either keep their original l5-year contracts, which were scheduled to expire in 2007, or to "extend [their] contract term[s] and pay [their] existing debt service obligation[s] over a longer period of time."[87] BP states that Kern River explained, in urging approval of the ET Settlement, that "the 'step-down' period which is used to collect the remaining ... investment costs ... would be extended to twenty years, instead of the currently approved ten-year period applicable to Kern River's current rates."[88] BP asserts that the 20 year period referred to by Kern River was consistent with the remaining service life of Kern River's system.[89] Morgan

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shipper's Period One contract to the conclusion of Kern River's depreciable life. Calpine Brief on Ex. at 11.

[86] Morgan Stanley Brief on Ex. at 11-12 (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at P 159; Opinion No. 486-D, 133 FERC ¶ 61,162 at P 172).

[87] *Id*. (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 14).

[88] BP Brief on Ex. at p. 20 (citing Exhibit No. BP-P2-12 at 2).

[89] BP Brief on Ex. at p. 20 (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 15; *Kern River Gas Transmission Co*., 92 FERC at 61,159 (recognizing that

(continued…)

Stanley also asserts that the ID's ruling contradicts the Commission's earlier holding that Period Two will last up to 28 years for some shippers. Morgan Stanley joins BP in arguing that that the Commission should require Kern River to use a levelization period that is coterminous with Period Two (not coterminous with the minimum contract period).[90] Calpine also argues that as of this ET Settlement order any link between the Period Two levelization period and the Original Certificate order has been severed.[91]

55. Calpine also asserts that the ID fails to show how its adoption of the 10-year Period Two originally set forth in the Original Certificate and based on a 25 year depreciation life has not been overtaken by Commission action on May 2000 where the Commission accepted a 15 year extension of Kern River's depreciable life through September 30, 2032 leaving the depreciable life at 40 years rather that the 25 years originally contemplated by the Original Certificate Order, and in Opinion No. 486, where the Commission adopted a remaining depreciable life of 35 years for Kern River, until October 31, 2039. Calpine argues that the system has changed to include far longer depreciable life than the 10-year period originally envisioned by the Original Certificate Order and the ID fails to recognize this.[92]

56. BP argues that the ID's claim that nothing in subsequent Commission orders suggested that the link between the levelization period and contract term should be disturbed is also in error. BP argues that none of the Commission's prior determinations with respect to Kern River (including the Original Certificate Order and the ET Settlement order) required Period Two contracts to be coterminous with the duration of the associated levelization and the Commission, in this proceeding has explicitly rejected the contention that Period Two contracts must be of the same duration as the associated levelization.[93] Moreover, BP argues that in both *Ingleside Energy Ctr., LLC*, 112 FERC ¶ 61,101 (2005)

Kern River's Period Two rates would be levelized over Kern River's remaining economic life, then 2032)).

[90] Morgan Stanley Brief on Ex. at 10.

[91] Calpine Brief on Ex. at 10.

[92] *See also* Morgan Stanley Brief on Ex. at 13.

[93] BP Brief on Ex. at p. 20 (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at P 254-256).

(*Ingleside*) and *Questar Southern Trails Pipeline Co*., 89 FERC ¶ 61,050, at 61,147 (1999) (*Southern Trails*) the Commission declined to find that a levelized cost of service must be coterminous with the related shipper contracts. Therefore, BP argues that it is clear that Commission precedent does not require that Kern River's levelization period be coterminous with contract terms.

57. Calpine adds that by unduly focusing on the Original Certificate Order and return of the Period One net regulatory liability, the ID fails to adhere to the levelization bargain actually struck by subsequent Commission orders and eliminates an important benefit of the levelization bargain for Kern River's shippers.[94] Calpine excepts to the ID's findings that strict coordination between Period Two levelization and contract terms is required to maintain the "original levelization bargain" set forth by the Original Certificate order, and that Kern River's levelized rate shippers understood the importance of such coordination. Calpine asserts that the ID's contention is contradicted on both points by Opinion Nos. 486-C and 486-D. Opinion No. 486-C found no clear evidence of an agreement or intent among the parties as to the relationship between Period Two levelization and contract terms.[95]

58. Kern River for its part, argues that the ID correctly adopted its proposal to equate contract terms and levelization periods for Period Two as just and reasonable. Kern River asserts that the Shippers' characterization of the ID's adoption of equal contract terms and levelization periods for Period Two service as inconsistent with prior Commission constitutes an improper, collateral attack on Opinion No. 486-D, where the Commission found that all options for "contract duration and the length of the levelization period" were open for consideration in the Period Two hearing.[96] Moreover Kern River asserts that the shippers also mischaracterize the ID's rationale as finding that the Original Certificate orders or other precedent requires 10-year levelization for Period Two, or that the levelization period and contract term must be coterminous.

59. Kern River argues that the ID's findings are consistent with the history of contract duration coterminous with levelization period since the inception of the Kern River system and Kern River's levelized rates. Kern River also argues that

[94] Calpine Brief on Ex. at 12.

[95] *Id.* P17.

[96] Kern River Brief op. Ex. at 35 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 200).

the ID's finding is consistent with the 10-year duration of Period Two contemplated by the Original Certificate orders and because this finding maintains the balance of risks of the levelization methodology.

Commission Determination

60. The Commission affirms the ALJ's adoption of Kern River's proposal that (1) Period One shippers be offered the option of entering into 10 or 15-year contracts for service during Period Two and that (2) its Period Two levelized rates should be designed to recover the entire 30 percent of its invested capital remaining at the end of Period One over the 10 or 15-year terms of those contracts.[97] However, the Commission requires that, at the end of those contracts, the Period Two shippers be offered service at stepped-down Period Three rates, reflecting removal from Kern River's rate base of all its original invested capital.[98]

61. As set forth above, Kern River's shippers assert that the ID erred by not requiring Kern River to levelize its recovery of the 30 percent of invested capital remaining at the end of Period One over Kern River's entire remaining depreciable life through October 31, 2039. The Commission denies this exception. As discussed in the preceding section, consistent with the structure of the NGA, the Commission gives the pipeline the initiative to propose remedial tariff provisions in section 5 proceedings. Therefore, if we are satisfied that Kern River's proposed levelization period and contract duration options are just and reasonable, we will adopt that proposal in preference to other just and reasonable remedies that may have been proposed by other parties. We find that Kern River has shown that its proposal to levelize its recovery of the remaining 30 percent of its original invested capital over the 10 or 15-year terms of shippers' Period Two contracts is just and reasonable.

62. In Opinion No. 486-D, the Commission held that the orders approving Kern River's optional certificate established rate design principles intended to apply for the life of its project and those principles included that the Period Two rates be levelized. The Commission explained that the fact Kern River's Period One levelized rates are designed to recover more of its invested capital during Period

[97] ID, 135 FERC ¶ 63,033 at P 1037.

[98] The ALJ acknowledged that Kern River also indicated that it would include a 15-year option for Period Two rates. ID, 135 FERC ¶ 61,003 at P 1040, n.304. Kern River is directed to include language encompassing this option in its compliance filing to the instant order.

One 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. The Commission further concluded that levelizing the Period Two rates is necessary to properly return the excess recovery. The Commission explained that traditional rates include a return on equity plus associated income taxes based on the rate base in effect at the end of the test period, and those rates remain the same every year – *regardless of declines in rate base* – unless and until they are changed by the pipeline or the Commission. Therefore, using traditional rates for Period Two would permit Kern River to earn a return on equity (plus associated income 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 NGA section 4 rate case or under NGA section 5. Because there would almost undoubtedly not be section 4 or 5 proceedings every year to modify the Period Two rates to reflect the declining rate base, Opinion No. 486-D concluded that traditional rates in Period Two would likely permit Kern River to earn an excessive return on equity. By contrast, levelized Period Two rates are 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 and minimizing the possibility of Kern River earning an excessive return.

63. Kern River's proposal is to levelize its recovery of the remaining 30 percent of its original invested capital over the 10 or 15-year terms of shippers' Period Two contracts returns its excess Period One recovery of invested capital, consistent with these holdings of Opinion No. 486-D concerning the rate design principles established by the orders approving Kern River's optional certificate. Kern River's excess recovery of its invested capital at the end of Period One is accounted for as a regulatory liability. Under Kern River's proposal, that regulatory liability is subtracted from the starting rate base used to determine the return on equity included in the Period Two rates. Levelized rates are then designed to reflect the decline in the net starting rate base to zero during Period Two as Kern River recovers the remaining 30 percent of its original invested capital.

64. Use of a 10 or 15-year levelization period does mean that the annual amount of depreciation paid by the Period Two shippers during the levelization period is greater, than if the longer levelization period, advocated by the shippers, extending to October 31, 2039 were used. On the other hand, Kern River's rate base declines faster, reducing the return on equity and associated income taxes that the shippers would otherwise pay over that period. Moreover, under the rate design principles approved in the original certificate order, at the end of the 10 or 15-year Period Two levelization period the shippers paying the Period Two rates will be entitled to stepped-down Period Three rates reflecting the removal of all of

Kern River's original invested capital from its rates. If Kern River shippers' proposal was adopted, they would have to wait until at least October 31, 2039, and, as discussed below, probably longer, before they would be entitled to Period Three rates.

65. In arguing that Kern River should be required to levelize its recovery of the remaining 30 percent of its original invested capital over its entire remaining depreciable life, Kern River's shippers emphasize that the Commission's orders in Kern River's original certificate proceeding described Period Two as covering the remainder of Kern River's then anticipated 25-year depreciable life. For example, in the Original Certificate Order, the Commission 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."[99] 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."[100]

66. However, since the original certificate proceeding, Kern River's anticipated depreciable life has continued to lengthen well beyond the original predicted 25-year life. In May of 2000, the Commission accepted a 15 year extension of Kern River's depreciable life (until 2032). Further, in Opinion No. 486, the Commission adopted a remaining depreciable life of 35 years for Kern River, until October 31, 2039, thus extending Kern River's depreciable life to about 49 years, or almost double the 25-year depreciable life contemplated by the Original Certificate order. Moreover, there is every reason to believe Kern River's depreciable life will continue to lengthen as new reserves are found, as is typical for natural gas pipelines.[101] Thus, if the Commission interpreted the rate design

[99] Original Certificate Order, 50 FERC at 61,150. Subsequent orders in the original certificate proceeding contained similar statements. January 1992 Amended Original Certificate Order, 58 FERC at 61,242-44, *order on reh'g*, 60 FERC at 61,437.

[100] *Id.*

[101] *See* Opinion No. 486, 117 FERC ¶ 61,077 at P 410 ("the Commission uses the economic life of the pipeline in determining depreciation. The economic life depends on the remaining gas supplies that will be available to the pipeline. The economic life must be adjusted, however, because not all assets are retired at the same time.") *Williston Basin Interstate Pipeline Co.*, 107 FERC ¶ 61,104, at

(continued…)

principles established in the original certificate proceeding as mandating that Period Two always extend to the end of Kern River's depreciable life, it is likely that in every future Kern River rate proceeding, the Period Two levelization period would be extended still further into the future. As a result, Period Two would be indefinitely extended, and the Period Three step-down rates would be indefinitely postponed. That would be contrary to the anticipation in the original certificate proceeding, that Kern River would have an opportunity to recover in its original invested capital in about 25 years, and thereafter shippers would pay reduced Period Three rates excluding any return on equity or associated income taxes on Kern River's original invested capital.

67. Therefore, at the time of the original certificate proceeding, shippers were fully aware that the Period Two rates were contemplated for a ten-year period. Admittedly, as pointed out by RCG and others, the Period Two anticipated at that time also corresponded with the anticipated depreciable life of the system. However, it shows that the parties expected at that time to pay rates recovering the remaining 30 percent of Kern River's costs over a 10 year period. Parties in this proceeding have not supported any other reasonable expectation.

68. Therefore, the Commission concludes that Kern River's proposal to give shippers the option of paying Period Two rates levelized over either 10 or 15 years is reasonably consistent with the rate design principles approved in the original certificate proceeding. Indeed, while the 15-year option is shorter than the projected 28 year remaining depreciable life at the start of Period Two for the 10-year shippers on the Original System, it is 50 percent longer than the 10-year duration of Period Two expected at the time of the original certificate proceeding. Moreover, as explained above, over the long-term, shippers will pay less under Kern River's proposal, than if we required Kern River to levelize its Period Two rates over its entire remaining depreciable life.

61,615 (2004) ("The dominant factor in determining the useful life, and therefore, the depreciation rates for gas facilities is the amount of reserves. The Commission must estimate the potential recoverable natural gas reserves available to the pipeline within a 'zone of reasonableness.'") (Footnote omitted). Determining a gas pipeline's depreciation rate requires forecasting "the probable useful life of the specific pipeline systems in question," based both on wear and tear and on the exhaustion of natural resources. *Memphis Light, Gas & Water Div. v. FPC*, 504 F.2d 225, 232 (D.C. Cir. 1974); *see also* 18 C.F.R. Part 201, Definition 12.B (2011).

69. The shippers contend that Kern River's Period Two levelization proposal is contrary to earlier holdings of the Commission in this rate proceeding, citing for example, Opinion No. 486 describing Period Two as "the period from the expiration of [Period One] contracts to the end of Kern River's depreciable life."[102] The Commission rejects such claims. The Commission did not decide any issue concerning Kern River's Period Two rates in Opinion Nos. 486 and 486-B other than requiring Kern River to include Period Two rates in its tariff. It was not until the Commission reviewed Kern River's first filing to comply with that requirement in Opinion No. 486-C that the Commission faced the issue of how those rates should be designed. At that time, the Commission recognized that "the present record is 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 levelization period,"[103] and therefore the Commission established a hearing on that issue. In Opinion No. 486-D, the Commission explicitly stated that "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."[104] The Commission from that point set out alternatives for resolving this issue and further stated that "[A]ll 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.[105]

70. Opinion No. 486-C stated that "the present record contains no indication that the parties fully considered or agreed upon the terms and conditions under

[102] Opinion No. 486, 117 FERC ¶ 61,077 at P 19.

[103] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 261.

[104] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 173. This finding was also consistent with the Commission statement in Opinion No. 486-C that "in this case, it may nevertheless be consistent with the parties' risk sharing agreements for Kern River to establish some method of coordinating contract length with rate levelization, such as a minimum contract length to which shippers must agree in order to be eligible for levelized rates during Period Two." Opinion No. 486-C, 129 FERC ¶ 61,240 at P 254.

[105] *Id.*

which Kern River would offer such levelized rates" for Period Two.[106] The hearing provided the shippers an opportunity to offer evidence concerning any contractual agreements with Kern River or other understandings at the time of the original certificate proceeding or subsequently that the levelization period for Period Two would extend for the entire depreciable life of Kern River regardless future extensions of that life. The shippers did not provide any such evidence. Thus, consistent with Opinion No. 486-D's recognition that "Kern River has no bilateral contracts with its shippers requiring it to offer levelized rates during Period Two,"[107] there are also no such bilateral contracts concerning the length of the Period Two levelization period. Therefore, so long as Kern River's proposed Period Two levelization period is consistent with the rate design principles underlying the original optional expedited certificate, the Commission will approve that proposed period. For the reasons discussed above, the Commission finds that the proposed levelization period is consistent with those rate design principles.

71. Kern River's proposal also requires Period One shippers to enter into contracts for the full 10 or 15-year levelization period they choose. Thus, the shippers must enter into a Period Two contract with a duration of at least 10 years. No shipper objects to such a minimum contract duration requirement. The shippers only contend that Kern River should permit them to enter into 10-year contracts, while Kern River's recovery of the remaining 30 percent of its invested capital is levelized over a substantially longer period. However, as the ID states, a levelization period that matches the term of the Period Two contracts is required in order to maintain the balance embodied in the original levelization package, and the Original Certificate Order that initially approved levelized rates recognized that shippers' service agreements were synchronized with their respective levelization periods.[108] The ID finds that this meant that the shippers on the Kern River system understood from the outset the importance of corresponding contract and levelization periods.

72. As noted, the Shipper Parties argue that the ID erred in finding that decoupling the contract terms from the levelization period imposes an unreasonable risk on Kern River, and that any approach which allows Period Two contracts to have a duration less than the Period Two levelization period is

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[106] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 257.

[107] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 120.

[108] ID, 135 FERC ¶ 63,003 at P 1041.

contrary to the risk-sharing arrangement memorialized in the Original Certificate Order. The Commission agrees with the ID's findings that, if contracts were permitted to be for less time than the levelization period, Kern River might be precluded from recovering all of the depreciation expense upon which the Period Two rates are predicated. As the difference in time between the contract term and the levelization period lengthens such differences require that recovery of more depreciation expense be deferred beyond the current contract terms. Therefore, a shipper could avoid paying for its portion of those deferred expenses by terminating service before those amounts were included in rates towards the end of the levelization period. This would disturb the risk allocation originally considered by the parties. Therefore, in order that all parties to the original bargain obtain the benefits of their bargain, the Commission finds that the ID did not err in approving Kern River's proposal that contract term and levelization period should be the same for Period Two.

73. Finally, RCG has raised concerns related to the end of the 10 or 15- year Period Two and fears that the rate may escalate to the maximum recourse rate in Kern River's tariff (which is currently the Period One 10-year 2003 expansion rate). The Commission agrees that at the end of their 10 or 15-year Period Two contracts, the Period Two shippers will be entitled to step-down Period Three rates, and any escalation of their rates to some higher level would be inconsistent with the rate design principles underlying the orders in the original certificate proceeding. The Commission previously found in this proceeding that it is not necessary for Kern River to include the future Period Three rates in its tariff at this time, and the Commission continues to believe that it would be premature now to attempt to calculate those rates which will not take effect for at least ten years. However, given the outcome of the hearing and the facts before it, the Commission now finds that the Kern River's tariff should include a requirement that Kern River file proposed Period Three rates sufficiently before the end of Period Two to permit Period Three rates to take effect at the end of Period Two.[109] At the end of the 10 or 15-year Period Two, shippers will have paid down their share of the remaining 30 percent of Kern River's original invested capital and will be entitled under the original bargain to new step down rates under Period Three.[110] Accordingly, for the same reasons the Commission held that it would be

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[109] Opinion No. 486-B, 126 FERC ¶ 61,240 at P 190-191.

[110] Moreover, in Opinion No. 486-D, that Commission determined that the usefulness of the Period One rate was over at the termination of the Period One contract stating:

(continued…)

unjust and unreasonable for Kern River to fail to offer Period One shippers stepped-down Period Two rates at the end of Period One, it would also be unjust and unreasonable for Kern River to fail to offer Period Two shippers stepped-down Period Three rates at the end of Period Two.

74. Therefore, the Commission requires that Kern River include in its tariff a provision that, on or before two years before the end of Period Two for the first set of expiring Period Two contracts, Kern River must file *pro forma* tariff sheets containing its proposed Period Three rates. The Commission finds that this is a necessary step in order to provide rate certainty to shippers taking service under Period Two and to permit the Commission to review the proposed Period Three Rates and ensure that such rates do not contain any costs related to Kern River's original investment in the subject facilities and to permit it time to consider any appropriate management fee for the rates in lieu of return on rate base.[111]

V. <u>Other Eligibility Requirements for Period Two Rates</u>

75. In the *pro forma* tariff sheets included in its February 1, 2010 compliance filing, Kern River proposed to add a new Section 30, entitled, "Period Two (Step-down) Rates," to the General Terms and Conditions of its FERC Gas Tariff.[112]

> [I]n 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. Opinion No. 486-D, 133 FERC ¶ 61,162 at P 175.

[111] *See Petal Gas Storage, L.L.C., v. FERC, et al.*, 496 F.3d 695 (2007) ("Typically, a pipeline receives a return on its net investment, which is measured by the pipeline's rate base. In the anomalous situation where a pipeline's assets have become fully depreciated, FERC policy provides that the pipeline may receive a 'management fee' in lieu of such a return.") *Id*. 702 (citing *Tarpon Transmission Co.*, 57 FERC ¶ 61,371, at 62,240 (1991) (*Tarpon*)). In *Tarpon,* the Commission permitted a management fee "to provide an incentive for efficient management and to mitigate the impact of the lower cash flow that will result from the determination that Tarpon has a zero net plant balance." *Tarpon* 57 FERC at 62,233.

[112] ID, 135 FERC ¶ 63,003 at P 1059-1061.

Pursuant to the proposed section 30, a Shipper would be eligible for Period Two rates if the shipper (or its successor, assignee or permanent replacement shipper) has paid the maximum applicable levelized rate for a full 10-year or 15-year term pursuant to the schedule set forth in proposed section 30.3.[113] Further, under the proposed section 30, the Shipper must notify Kern River in writing of the Shipper's intent to contract for firm transportation service in Period Two no less than 12 months before the expiration of its Period One contract.[114] In addition, the Shipper must execute a standard, KRF-1 service agreement for Period Two service for a term of 10 years (Exhibit Nos. KR-P2-2, KR-P2-1, at 13-14; or the 15-year option).[115]

A. Notice Period

76. The ALJ accepted Kern River's proposal to require Period One shippers (other than 10-year Original System shippers) to provide 12 months notice of their intent to contract for service during Period Two,[116] and found such a notice period to be just and reasonable.[117] The ALJ finds that Kern River's clarification at the hearing that a good faith filing at the 12- month mark will merely provide a

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[113] According to proposed section 30.3, the 10-year, Rolled-in Period Two rate is available on October 1, 2011 for original Rolled-in System Shippers that have contracts set to expire on September 30, 2011.

[114] Section 30.2(a) states that: "[E]ligible Shipper must notify Transporter in writing of its intent to enter into a Period Two transportation service agreement not less than twelve (12) months prior to the expiration of its Period One transportation service agreement."

[115] Section 30.2(a) states that: "[A]n Eligible Shipper that wishes to retain its capacity at the expiration of its Period One transportation service agreement must enter into a new, standard form firm transportation service agreement under Rate Schedule KRF-l for a term of ten (10) years."

[116] ID, 135 FERC ¶ 63,003 at P 1058. The ALJ noted that Kern River has agreed to only a six month notice period for the 10-year Original System Shippers, whose Period One contracts expire on September 30, 2011; Exhibit No. KR-P2-1, at 15.

[117] ID, 135 FERC ¶ 63,003 at P 1074 (citing Exhibit No. KR-P2-9, at 17-18).

placeholder for Shippers mitigated their concerns about being required to give such notice 12 month's in advance.[118]

77. Morgan Stanley argues that the ID erred by failing to address arguments that a one-year notice period is unnecessary. Morgan Stanley argues that because Kern River has had firm contracts for 100 percent of the capacity of its Original System since at least 2002, the competitive conditions in Period Two—including the lower Period Two rates—will not require a one-year notice period for the remarketing of any capacity that remains unsubscribed after Period One and, therefore, requiring a one-year notice from shippers is unjustified. Morgan Stanley points out that because Kern River has already agreed to a six-month notice period for 10-year Original System Shippers, a six-month notice period is appropriate for all eligible shippers electing Period Two service.[119]

78. Nevada Power, a 10-year shipper on the Original System whose Period One contract expires on September 30, 2011, requests that the Commission strike any prior notice requirement unless and until there are Period Two rates and terms of service in effect, including the contract term options available to shippers. Nevada Power argues that it is unfair to require shippers to contract for long-term service prior to knowing the term of contract options, rates and other conditions of service.[120]

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[118] ID, 135 FERC ¶ 63,003 at P 1071 (citing Tr. Vol. 3, at 195-196:

> But to explain it so we make sure all Kern River customers understand what the notice under these *pro forma* tariff sheets is contemplated to be, we will use the 10-year rolled-in-Shippers as an example. April 1st is the deadline to provide notice of intent to utilize Period 2 service or acquire Period 2 service. If a customer in good faith tells us by that deadline that they intend to take Period 2 service, then the ensuing six months are for the process of developing a contract and getting a contract signed by the time Period 2 starts on October 1. If the customer does not sign a contract, then the Period 2 service won't be provided. Under current service agreements, that's the end of it).

[119] Morgan Stanley Brief on Ex. at P 21.

[120] Nevada Power Brief on Ex. at 27.

79. In opposition to these exceptions, Kern River argues that the ID did not fail to address the arguments that the one-year notice period was unnecessary. Rather Kern River states the ID addressed the arguments and found that "the testimony and rationale that the notice provision is reasonable, as provided by [Kern River's witness] Mr. Dushinske on this issue, to be very probative."[121] Kern River argues this testimony reveals that a 12-month notice requirement is "a reasonable estimate that balances the shippers' interests and those of Kern River," because Kern River must go through the "process of soliciting interest in unsubscribed capacity, negotiating potential agreements or other service parameters, and consummating sales[, which] – particularly in the buyers' market that is likely to prevail – is likely to require significant time and resources."[122]

80. Kern River argues that Morgan Stanley fails to provide any justification for its preferred notice period of six months and merely asserts that the one year notice period strikes an improper balance in favor of Kern River while presenting no evidence or other factor that the ALJ purportedly did not weigh.

81. Lastly, Kern River asserts that Nevada Power's argument does not rest on the length of the notice period but rather whether a shipper must submit a notice to preserve its rights to service at Period Two rates before the rates are established. Kern River states that this argument was considered and rejected by the Commission in Opinion No. 486-D.[123]

Commission Determination

82. The Commission finds that the ALJ appropriately considered testimony and found that the testimony offered by Kern River's witness compelling concerning the issue of a twelve month notice period for contracting for Period Two rates for shippers other than the 10-year Original System shippers whose contracts expire on September 30, 2011. The Commission finds as argued by Kern River that Morgan Stanley has failed to provide any reason or evidence for the Commission to consider in order to compel it to overturn the ALJ on this matter. Indeed, the Commission has previously found that 12-month notice periods are reasonable to

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[121] Kern River Brief op. Ex. at 47 (citing ID, 135 FERC at P 1074; Ex. No. KR-P2-9 at 17-18).

[122] Kern River Brief op. Ex. at 47 (citing Ex. No. KR-P2-9 at 17-18).

[123] Kern River Brief op. Ex. at 47 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 189).

impose on shippers wishing to invoke their right of first refusal in order to renew expiring contracts.[124]

83. However, in the circumstances of this case, the 12-month notice requirement cannot be applied to 10-year Original System Shippers with contracts expiring in less than three months on September 30, 2011. On May 26, 2011, after the ID issued, the Commission issued an order addressing a limited section 4 filing by Kern River to clarify the process by which those shippers would retain capacity when their contracts expire.[125] Under Kern River's proposal, those shippers would have been required to submit a binding and non-conditional expression of intent that they would execute a service agreement for Period Two service with a term of either 10 or 15 years or forfeit their right to take Period Two service under the step-down Period Two rates required by the Commission. The Commission rejected Kern River's proposal stating that:

> Kern River's instant proposal would require the Affected Shippers to make binding commitments as to the duration of the contracts they will enter into before the Commission has resolved that issue based on the record developed at the Period Two hearing and the parties' briefs on exceptions to the ALJ's initial decision.[126]

84. Accordingly, while the Commission finds that the ALJ's determination that a one year notice period is appropriate for all Period One shippers other than those with contracts expiring on September 30, 2011, a different approach is necessary for the 10-year Original System shippers. This order is resolving all issues concerning the Period Two rates for those shippers and the eligibility conditions they must satisfy in order to contract for Period Two service. Kern River must make a compliance filing calculating Period Two rates consistent with the holdings of this order on or before August 5, 2011. In these circumstances, the Commission finds that the 10-year Original System shippers will have sufficient information concerning Period Two contract rates and conditions of service, so that it is just and reasonable to require them to make a binding and non-conditional

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[124] *Equitrans LP*, 99 FERC ¶ 61,219, at P 97 (2002) ("With respect to the notice period for exercising the ROFR, the 12-month notice period is reasonable and is similar to the other notice periods previously accepted by the Commission.") (footnote omitted).

[125] *Kern River Gas Transmission Co.*, 135 FERC ¶ 61,179 (2011).

[126] *Id*. P 24.

commitment on or before September 1, 2011 to execute a service agreement for Period Two service with a term of either 10 or 15 years.

B. Roll-Over of Period Two Contracts

85. The ID noted that no party disputes that each eligible Period One Shipper should be allowed to contract for any quantity up to its Period One maximum daily contract quantity. The ID also found merit in Kern River's proposal that the determination of Period Two capacity entitlements is a one-time election, made prior to the beginning of Period Two, which conclusively establishes a Shipper's right to Period Two service at the applicable step-down rate.[127] Kern River argues that a one-time election fairly balances the step-down benefit for all eligible Period One Shippers against the risk Kern River bears of marketing any unsubscribed Period Two capacity.

86. The RCG contends that the ID's finding that there must be a one-time election for Period Two rates at the 10- or 15-year term is erroneous to the extent it may prohibit the roll-over of an initial Period Two 10- (or 15) year contract during the remainder of Period Two. Calpine argues that the ID erred by rejecting a unilateral right for shippers to extend their levelized rate service beyond their initial Period Two contracts. Calpine states that such action reduces levelized rate shippers' Period Two rights and appears to eliminate their Period Three rights entirely. The Southern California Generation Coalition asserts that, if customers were denied a roll-over right and instead were required to take service at recourse rates after the first ten years of Period Two, Kern River would be able to avoid returning the regulatory liability that it accrued during the first ten years of Period Two.

87. The Commission finds that these contentions are addressed by our holdings above concerning the duration of Period Two and the right of shippers contracting for Period Two service to obtain service at Period Three rates upon the completion of their Period Two contracts. The issue of rolling over a Period Two contract for additional Period Two service after the term of the initial Period Two contract will never arise, because the end of Period Two would be reached by the end of the initial Period Two contract and the Shipper reaching the end of its Period Two contract would now be eligible for Period Three rate as described above.

[127] ID, 135 FERC ¶ 63,003 at P 1077 (citing Exhibit. No. KR-P2-19, at 27).

C. Reservation of Turned-back Period One Capacity for other Period One Shippers

88. Kern River has proposed to require Period One shippers to make a one-time election whether to execute a contract for Period Two service. When a Period One shipper makes that election, it may contract for service up to its contractual entitlement for Period One service, but no more. At the hearing, BP contended that any capacity turned back by a Period One shipper at the end of Period One must be reserved for use by other Period One shippers during Period Two. BP argued that this was necessary in order assure that Kern River returns the excess depreciation collected during Period One.

89. The ID finds that the fact that certain Period One Shippers may not take service under 4 step-down rates in Period Two has no bearing on whether Period Two rates for those who are eligible are properly calculated to provide the benefit of the Period One accelerated depreciation. Likewise, the ID finds that BP fails to support its assertion that Kern River's illustrative Period Two rates are somehow deficient because they lack any "mechanism that ensures" the Period One accelerated depreciation is "returned" to shippers in Period Two.

90. The ID states that the Commission has ruled that Shippers have no right to "derive any benefit from Kern River's [Period Two] rate methodology" unless they contract for service during Period Two.[128] For eligible Shippers that elect to contract for Period Two service, the accelerated depreciation paid during Period One is returned by crediting against rate base the net regulatory liability accrued at the end of Period One – i.e., by calculating Period Two rates to recover the approximately 30 percent of Kern River's investment that will remain un-depreciated at the end of Period One.[129] The ID states that Kern River's illustrative Period Two rates are so calculated.[130] The ID therefore finds that Kern River's rates will properly return the accelerated depreciation paid during Period One.

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[128] ID, 135 FERC ¶ 63,003 at P 1007 (citing Opinion No. 486-B, 126 FERC ¶ 61,240 at P 183).

[129] *Id*. (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 49-50, *order on reh'g,* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 45, *order on reh'g,* Opinion No. 486-B, 126 FERC ¶ 61,240 at P 182).

[130] *Id*. (citing Exhibit No. KR-P2-5, at 5; Exhibit. No. KR-P2-3 at 6 (Kissner Opening Testimony)).

Briefs on and Opposing Exceptions

91. On exceptions, BP states that the rates for Period Two were designed to be lower than the Period One rates so that the excess depreciation paid to Kern River during Period One would be returned to shippers during Period Two. However, BP argues that the ID does not implement any mechanism to ensure that all of Kern River's Period One excess depreciation recoveries are returned to shippers during Period Two, if for example, a certain Period One shipper does not qualify or chooses not to subscribe for Period Two service. BP asserts that the ID inappropriately dismisses this concern, holding that "the fact that certain Period One Shippers may not qualify for [or elect not to subscribe for] step-down rates in Period Two has no bearing on whether Period Two rates for those who are eligible are properly calculated to provide the benefit of the Period One accelerated depreciation."[131]

92. BP argues that the ID is incorrect because the Commission determined that Kern River's levelized Period One rates are only just and reasonable if all excess depreciation collected by Kern River during Period One is returned to shippers during Period Two.[132] Therefore, BP argues that Kern River may not retain the depreciation over-recovery from Period One during Period Two. BP asserts that any Period One capacity eligible for Period Two rates that is turned-back or not contracted for by a particular shipper should be reserved for the benefit of other shippers eligible for Period Two service. BP states that if Kern River is not required to offer all Period One capacity eligible for Period Two rates for subscription by Period One shippers, Kern River might overrecover its allowed return.

93. BP states that Kern River has asserted a right to sell unsubscribed Period Two eligible capacity for the highest recourse rate in its tariff. BP states that because such a rate will be higher than any Period Two step-down rate Kern River could obtain a windfall. Therefore, BP asserts that all capacity subject to the over-collection of depreciation during Period One should be reserved for use by Period One shippers during Period Two. It maintains that each electing shipper must have the ability to convert all of its Period One Capacity to the lower Period Two rates. BP asserts that if there is any remaining Period One capacity, it should be made available for any former Period One shipper that has contracted for capacity

[131] BP Brief on Ex. at 11 (citing ID, 135 FERC ¶ 63,003 at P 1005).

[132] BP Brief on Ex. at 11 (citing Opinion No. 486-A, 123 FERC ¶ 63,056 at P 60-61).

in Period Two. BP argues that the Commission should direct Kern River to offer all Period One capacity eligible for Period Two rates for subscription by Period One shippers before Kern River is permitted to sell such capacity at non-Period Two rates.

94. Kern River responds that in Opinion No. 486-B, the Commission ruled that shippers have no right to "derive any benefit from Kern River's [Period Two] rate methodology" unless they contract for service during Period Two and therefore BP's concern regarding shippers that do not participate fully in Period Two is irrelevant.[133] However, Kern River asserts that for participating shippers the Period Two rates will return the accelerated depreciation paid during Period One by crediting against rate base the net regulatory liability accrued at the end of Period One by calculating Period Two rates to recover the approximately 30 percent of Kern River's initial capital investment that will remain undepreciated at the end of Period One.

95. Kern River also argues that it will not realize any windfall by collecting its recourse rate for some service during Period Two if some eligible shippers do not qualify for, or elect not to take advantage of, Period Two rates. Kern River argues that any resulting capacity will be posted as available for service to any qualified, requesting party. Kern River states that this does not either harm Period One shippers, or grant it a windfall.

Commission Determination

96. The Commission affirms the ALJ on this issue and rejects BP's contention that any Period One capacity eligible for Period Two rates that is turned-back or not contracted for by a particular shipper should be reserved for the benefit of other shippers eligible for Period Two service. The Commission rejected a similar contention by BP in Opinion No. 486-C. BP had requested that the Commission require that the excess depreciation recovered during Period Two be flowed back to the same capacity from which its was obtained and that, if the same shippers do not retain capacity in Period Two, the Commission must nevertheless explain how Kern River will be prevented from retaining the excess revenue. The Commission declined to grant this clarification, stating that it had required that the excess depreciation amounts be recorded and that the Period Two rates be calculated to return any excess amounts to the shippers during Period Two. Opinion No. 486-B further stated:

[133] Kern River Brief op. Ex. at 27 (citing Opinion No. 486-B, 126 FERC ¶ 61, 240 at P 183).

> The bargain in this proceeding is based upon continued use of the facilities. If a shipper determines that it is in its best interest to terminate service at the end of its current contract and thereby forego the benefit of Period Two rates, the Commission will not require any special modification of the Period Two or Period Three rates to reflect this fact other than the usual change in the rate design volumes that would occur in a pipeline's next rate case.[134]

97. The Commission's requirement that Kern River offer Period One shippers stepped-down levelized Period Two rates reflecting the regulatory liability arising from the excess recovery of depreciation guarantees each Period One shipper the opportunity to obtain the return of any excess amounts it paid during Period One. However, under this mechanism if a shipper does not avail itself of the Period Two rates to recoup the excess depreciation, the Commission was clear that it would not require any special modification of the Period Two or Period Three rates to reflect this fact.

98. If a Period One shipper eligible for Period Two rates does not contract for service during Period Two, Kern River may offer such capacity as generally available at its recourse rate. Such a rate is just and reasonable and is available to all shippers. The Commission finds that any argument that other Period One shippers should be permitted to obtain such newly available Period Two capacity at the Period Two rate before it is offered generally to all shippers is without merit. Neither BP nor other shippers have pointed to anything in the Commission's orders in the original certificate proceeding or subsequently providing for such a preferential right to additional capacity which they did not contract for during Period One. The shippers participating in the original allocation of risk and entering into contracts for Period One service did so as individuals; there is no group right to receive any excess payments of depreciation in Period One paid by other members of the group. If any eligible Period Two shipper declines to avail itself of its rights to capacity at the Period Two rate which will return to it the excess payments it made in Period One, Kern River is not required to offer such capacity to other Period Two shippers at the Period Two rate because such shippers did not bargain for this right to each others capacity.

99. Any excess depreciation amounts Kern River retains because of Period One shippers declining to contract for service during Period Two, or revenues Kern

[134] Opinion No. 486-B, 126 FERC ¶ 61,240 at P 183.

River receives from sales of such turned-back capacity, may be considered in determining Kern River's cost of service, cost allocation, and rate design volumes in any future Kern River rate case. Further, given this discussion the Commission also rejects Nevada Power's assertion that the ID improperly dismissed its argument that the design of Period Two rates should include a tracker to credit Period Two shippers with Kern River's excess revenues in a pipeline's next rate case.[135] Nothing in the original certificate orders suggests that such a tracking mechanism would be required in Kern River's Period Two rates.

D. Rate Schedule KRF-1

100. In its original certificate proceeding, Kern River proposed to provide transportation service to four shippers under individually negotiated terms and conditions which were reflected in the customers' respective service agreements rather than under the General Terms and Conditions in its tariff. In a November 2, 1990 order in that proceeding,[136] the Commission directed Kern River to incorporate the terms of these service agreements within the General Terms and Conditions so that other shippers who so requested could receive service under the same terms and conditions that were available under the terms of the service agreements. In its November 29, 1991 compliance filing, Kern River filed new Rate Schedules CH-1, SH-1, MO-1, and UP-1 to reflect the terms of its service agreements with the four shippers, making such terms available to others on an open access basis. Kern River's tariff continues to include those four rate schedules in addition to its standard firm open access transportation Rate Schedule KRF-1, and Nevada Power and certain shippers in the Rolled-in Customer Group continue to take service under those four rate schedules. They refer to their contracts for service under these four rate schedules as the "Self Contained Contracts."

101. In its Period Two compliance filing, Kern River proposed to require that all Period One shippers wishing to contract for Period Two service at step-down rates

[135] Nevada Power Brief on Ex. at 34-35

[136] *Kern River Gas Transmission Co.*, 53 FERC ¶ 61,172, at 61,632-3 (1990) *order on reh'g*, 55 FERC ¶ 61,089, at 61,270 (1991); *Kern River Gas Transmission Co.*, 60 FERC ¶ 61,128, at 61,456 (1992).

must enter into a "new, standard form firm transportation service agreement under Rate Schedule KRF-1."[137]

Initial Decision

102. The ALJ approved this proposal over the objection of some Kern River shippers. Those shippers opposed the uniform application of the KRF-1 service agreement for Period Two service, asserting that each respective shipper should not be limited to the terms and conditions contained in Rate Schedule KRF-1 but rather should be permitted to retain the features associated with their respective Period One agreements.[138] On the other hand, Kern River argued that the shippers' desire to retain such contracts fell short of justifying exercise of the Commission's authority under NGA section 5 to require the incorporation of such terms and conditions in new contracts governing Period Two service. Kern River contended that the terms sought to be continued by the shippers were agreed to as part of the original arrangements under which Kern River agreed to establish and maintain levelized rates for the duration of Period One and that there was no such agreement regarding service in Period Two. Kern River argued that to permit shippers to retain provisions of their Period One contracts without Kern River's agreement, would be arbitrary and capricious.

103. The ALJ found that the arguments supporting placing customized terms and conditions from the original system contracts negotiated in 1989 into shippers' new Period Two contracts have not been justified and would selectively confer on certain shippers operational advantages that are not part of Period Two service.[139] The ALJ noted that many shippers now have a standard, KRF-1 agreement and agreed with Kern River's position that parties opposing use of the standard, KRF-1 service agreement did not demonstrate any expectation that their vintage, non-conforming, terms and conditions would extend beyond Period One.[140] Accordingly, the ALJ found that the shippers' desire for flexibility does not

[137] ID, 135 FERC ¶ 63,033 at P 1067-1073 (citing Exhibit No. KR-P2-2, at 1).

[138] ID, 135 FERC ¶ 63,033 at P 1069.

[139] *Id.* P 1098 (citing Exhibit No. KR-P2-19 at 22).

[140] *Id.* P 1099.

outweigh Kern River's need for efficiency of administration and that Kern River's proposed use of the standard form is just and reasonable.[141]

104. Moreover, the ID finds that the requirement that all shippers contract for Period Two service pursuant to Kern River's standard form, KRF-1 service agreement was designed to ensure equal, non-discriminatory, access to Period Two service for all eligible shippers and is supported by the record. The ALJ found that to require the standard Rate Schedule KRF-1 was consistent with Commission policy favoring use of standard form contracts over non-conforming, customized agreements.[142]

Briefs on and Opposing Exceptions

105. On exceptions, Nevada Power argues that continued service during Period Two under Rate Schedules CH-1, SH-1, MO-1, and UP-1 would be no different in legal effect than continued service during Period Two under Rate Schedule KRF-1. Nevada Power asserts that Kern River simply seeks to extend this one currently effective Period One Rate Schedule into Period Two because it would reduce the flexibility of service it would be obligated to continue for its Original System shippers. Nevada Power argues that the ID failed to consider that the Commission previously rejected complaints that continued service under Rate Schedules such as MO-1 rather than under the KRF-1 Rate Schedule would be unduly discriminatory.[143] Further, Nevada Power states that the Commission has not determined that these rate schedules are temporally limited but rather it required Kern River to provide service under rate schedules such as MO-1 to all shippers that request service using the original system capacity.[144] Further, Nevada Power argues that there is nothing in Rate Schedule MO-1 or in Rate Schedule KRF-1 that would prevent shippers from electing to continue service beyond the initial terms of any of those agreements and Rate Schedules.

106. RGC argues that there is no legal basis for restricting their roll-over rights to utilize the Self Contained contracts to qualify for Period Two rates and that these

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[141] *Id.* P 1100.

[142] *Id.* P 1070.

[143] Nevada Power Brief on Ex. at 25.

[144] Nevada Power Brief on Ex. at 25 (citing *Kern River Gas Transmission Co.*, 60 FERC at 61,456).

Contracts provide for certain terms that are not provided in the general firm rate schedule KRF-1, but which have been approved twice by the Commission.

107. Moreover, RGC argues that the ID did not consider the inconsistent testimony of Kern River on the record regarding this issue. RGC argues that Kern River provided two data responses which confirm the rights of the subject contracts not only to roll over, but also to qualify for Period Two rates.[145] RGC argues that after making these statements, Kern River cannot maintain that the Self Contained Contracts cannot be rolled over into Period Two and qualify for Period Two rates. RGC asserts that Kern River's testimony that shippers had no expectation that their contracts would be extended is not defensible in light of this evidence and by the roll-over terms included in the contracts.

108. RGC argues that the ALJ's findings that: (1) there was no agreement that these arrangements would be in effect for Period Two; (2) the agreements are inconsistent with Commission policy favoring standard form contracts, (3) the agreements provide the shippers with a competitive advantage, (4) the agreements violate the policy that the capacity should be allocated to those who place the highest value on it, and; (5) continuation of the individual agreements is administratively burdensome, are not supported by the record or Commission precedent.

109. RGC argues that there was agreement that the individualized contracts would remain in effect for Period Two because each of the contracts has roll-over rights, and Kern River stated in data requests that these contracts would qualify for

[145] RGC Brief on Ex. at 33 (citing Exh. No. RCG-6, at page 3 of 3). RGC states this Kern River response to a Data Request provides a table that lists those shipper contracts (by contract number) that Kern River stated would be eligible for Period Two Step-down rates. RGC states these contract numbers include the following: Contract Number 1007 (Aera's SH-1 contract), Contract Number 1005 (Anadarko's UP-1 contract), Contract No. 1002 (Chevron's CH-1 contract), and Contract No. 1502 (Shell Energy's MO-1 contract). RGC states that this data response was submitted by Kern River was dated November 16, 2010, after Kern River's testimony was filed in which Ms. Miller stated that those contracts would not be eligible for Period Two rates. Moreover, that data response is consistent with an earlier data response, entered into the record as Exhibit No. RCG-7, in which Kern River was asked to identify which contracts would not qualify for the Period Two step-down rates, and none of the individualized contracts were identified as not qualifying.

Period Two service.[146] Therefore, RGC argues that there is no support for the ID's conclusion that "there is no such agreement regarding service in Period Two."[147] Further, RGC asserts that Kern River's argument that the roll-over rights for successive year-to-year extensions are somehow inconsistent with the Period Two duration term. RCG states that this is not a legal obstacle because there is nothing that would prohibit an agreement to roll the contracts over for the number of years that coincides with whatever minimum Period Two contract term is determined for in this case.

110. RGC also asserts that the findings of the ALJ that the subject contracts are inconsistent with Commission policies are unsupported because the Commission has approved these contracts as discussed above. RGC argues that there is no merit to Kern River's claim of administrative burden that was adopted in the ID because maintaining these contracts in the future for Period Two service will be no more burdensome than maintaining their existence in the past. policy basis to deny these shippers the right to roll over their individualized contracts to access Period Two rates and services.

111. Kern River responds that the ID's conclusion that Rates Schedule KRF-1 Form of Service agreement should be the foundation of service under Period Two is justified. Kern River argues that the essence Nevada Power's argument is that taking Period Two service under one of the Self Contained contracts "would be no different in legal effect" from service under Rate Schedule KRF-1. Kern River agrees that all the rate schedules in question provide for firm but asserts that no shipper will be harmed by taking Period Two service under Rate Schedule KRF-1, and that the only *pro forma* service agreement in Kern River's tariff is for service under Rate Schedule KRF-1.

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[146] Citing, Item by Reference RCG-A, Section 8.2 of Rate Schedule CH-1, at 2 of 14 (at the end of the initial term, Shipper shall have the election to extend the Agreement for a period up to and including 15 years); Section 7.2 of Rate Schedule UP-1, at 7 of 14 (Shipper shall have the continuing option to extend the term of the Transportation Service Agreement at the same or lower DMDQ for one or more additional one-year periods); *id*. at Section 7.2 of Rate Schedule MO-1 at 10 of 14; and Section 3.1 of Rate Schedule SH-1, at 13 of 14 (Shipper shall have the option to extend the term of the Firm Transportation Service Agreement for one or more extended periods of at least twelve months).

[147] Citing ID, 135 FERC ¶ 63,033 at P 1070.

112. Kern River also states that Nevada Power overlooks terms of the self-contained rate schedules that preclude their availability for service at Period Two rates in that each of the Self Contained contracts state that it is that it is available for service only "within the contract term" of the corresponding, self-contained contract which the rate schedule incorporates into the tariff. However, the primary terms of the self-contained contracts do not include any portion of Period Two and the term extensions of those contracts cannot properly be exercised to continue or obtain service at levelized, Period Two rates.[148] Lastly, Kern River argues that Nevada Power fails to show any intention by the contracting parties to apply the non-conforming terms of the Self Contained contracts to Period Two service under levelized rates, or what Nevada Power would purportedly would lose by signing a conforming, KRF-1 service agreement for Period Two service.

113. Kern River argues that RGC supports a minimum contract term of 10 years for Period Two service, and agrees that it would be discriminatory for shippers within the same rate group to have different contract terms. Kern River argues that this is inconsistent with permitting shippers to obtain service at Period Two rates pursuant to the extension terms of the Self Contained agreements. Kern River states that RGC relies on the unilateral extension terms of the Self Contained contracts to argue that the shippers under the self-contained agreements should be able to retain unspecified "certain terms that are not provided in the general firm rate schedule KRF-1." However, Kern River argues that some of these Self Contained contracts provide only for year-to-year extensions and other forms of contract extension which do not correspond with the minimum, 10-year duration for Period Two service endorsed by RCG. This, Kern River argues, would alter the cost recovery risk allocated to Kern River.

114. Kern River argues that RCG failed to show any evidence of harm to any shipper under a Self Contained agreement resulting from replacing the shipper's current contract at the end of its primary term with a new, conforming agreement under Rate Schedule KRF-1. Kern River argues that the record offers no justification for providing Period Two service on unspecified, preferential terms to a favored group of shippers that will be eligible for Period Two rates.

115. Kern River also argues that the Commission's policies on material deviates from pro forma service agreements support its proposal to require all Period Two shippers to ship under Rate Schedule KRF-1 contracts. Kern River argues that RCG has asserted that shippers under the Self Contained contracts should be able to retain the non-conforming terms of their current agreements in Period Two

[148] Kern River Brief on Ex. at 63-64, n.168.

because of the Commission's acceptance of the original contracts as not unduly discriminatory in 1990, prior to Kern River's commencement of operations.[149] Kern River responds that the fact that such contracts were not unduly discriminatory at that time is not controlling today. Kern River argues that the Commission in 2001 clarified that it must review every contract term that materially deviates from the applicable, *pro forma* service agreement under a pipeline's tariff, [150] to determine whether each material deviation is one that presents the potential for undue discrimination.

116. Kern River further argues that RCG's proposal here to contemplate new service elections by the shippers under the Self Contained Contracts, to be implemented through unilateral contract amendments violates the Commission's application of its material deviation policy as it expressed in *Texas Gas*.[151] Kern River states that in *Texas Gas* the pipeline and a shipper carried forward a non-conforming provision of a prior, long-term contract into a new agreement which they described as an extension and replacement of their prior contract. The Commission stated that it previously suggested that such non-conforming provisions may be permissible if part of a longstanding agreement entered into prior to the Commission's clarification of it material deviation policies but that this exception was not applicable where "[t]he parties are not relying on their rights under an existing service agreement; rather, they wish to carry forward a non-conforming provision into a new service agreement."[152] Therefore, Kern River argues that RGC proposal also violates the Commission's material deviation policies. Moreover, Kern River points out that RCG has failed to identify the particular non-conforming terms of the self-contained contracts that it wants to extend into Period Two, and, therefore argues that RGC cannot withstand review of such non specified provisions pursuant to *Texas Gas*.

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[149] Kern River Brief op. Ex. at 61 (citing *Kern River Gas Transmission Co.*, 53 FERC ¶ 61,172).

[150] Kern River Brief op. Ex. at 61 (citing *inter alia*, *Columbia Gas Transmission Corp*., 97 FERC ¶ 61,221 (2001); *ANR Pipeline Co*., 97 FERC ¶ 61,222 (2001)).

[151] Kern River Brief op. Ex. at 71 (citing *Texas Gas Trans., LLC*, 131 FERC ¶ 61,052 (2010) (*Texas Gas*)).

[152] Kern River Brief op. Ex. at 71 (citing *Texas Gas*, 131 FERC ¶ 61,052 at P 11).

Commission Determination

117. As set forth at length above, the Commission bears the burden of proof in this NGA section 5 proceeding to show that the remedy it has adopted to satisfy the second prong of the section 5 burden results in just and reasonable rates and practices to be thereafter followed. Based upon the instant record, the Commission cannot find that Kern River's proposal to require Period Two shippers to reject their Self Contained contract in order to receive Period Two transportation service under Rates Schedule KRF-1 is necessary in order to establish just and reasonable rates for Period Two.

118. In the original certificate proceeding, the Commission found the Self Contained Contracts at issue here to be just and reasonable and not unduly discriminatory.[153] Further, as the Commission required in Kern River's original

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[153] In *Kern River Gas Transmission Co.*, 53 FERC at 61,632-3, the Commission stated:

> The Commission further notes that, by virtue of the compliance filing and the prior notice filings, all of the service agreements have been made available for inspection by all of the potential shippers. No potential shipper has filed a complaint or a protest alleging undue discrimination. Customers that request Part 284 transportation service after the facilities become operational must be afforded the opportunity to receive service under the General Terms and Conditions, which must include as options the same terms and conditions that were available in the specific service agreements reflected in the tariff.

Subsequently, on rehearing of its order, the Commission stated:

> In light of the broad scope of negotiations contemplated under the optional procedures, the Commission held in the November 2, 1990 order that different service agreements for different customers were not per se unduly discriminatory. In other words, the mere fact of differing service agreements for different customers is not, in itself, evidence of undue discrimination. . . . In this case, the evidence demonstrated that Kern River's customers had the same opportunity to negotiate service agreements with the pipeline and that the customers were satisfied that this was the case. In the absence of customer complaints, the Commission correctly concluded that there

(continued…)

certificate proceeding, these Self Contained Contracts comprise open access rate schedules that are available to all Kern River shippers.[154] Kern River has not proposed to remove the Rate Schedules containing the Self Contained Contracts from its the Open access tariff. Thus, any shipper can avail itself of these Self Contained contracts, including new shippers. To require shippers wishing to avail themselves of their right to access Period Two rates as set forth herein, to relinquish their open access Self Contained contracts may unnecessarily discriminate against such Period Two shippers, particularly when the Rate Schedules setting forth the Self Contained contracts remain as open access rate schedules under Kern River's tariff for all non-Period Two shippers to use.

119. In addition, the fact that the Self Contained Contracts are offered on an open access basis to all shippers means that they do not constitute impermissible material deviations from Kern River's *pro forma* service agreement for KRF-1 service. As the Commission explained in *Columbia Gas Transmission Corp.*,[155] the Commission requires contracts which deviate from the pro forma service agreement in the pipeline's tariff to be filed in order to carry out the requirement of NGA section 4 that all contracts which affect the pipeline's service "in any

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was no evidence of undue discrimination in the contract negotiation process. 55 FERC ¶ 61,089 at 61,270 (1991).

[154] *See Kern River Gas Transmission Co.*, 60 FERC at 61,456 ("In a July 24, 1990 filing, Kern River proposed, *inter alia*, to provide transportation service to four shippers under individually negotiated terms and conditions which were reflected in the customers' respective service agreements rather than under the General Terms and Conditions contained in Volume No. 1 of its FERC Gas Tariff. In the Compliance Order, the Commission directed Kern River to modify its tariff to incorporate the terms of these service agreements within the General Terms and Conditions so that customers who so requested could receive service under the same terms and conditions that were available under the terms of the service agreements. In its November 29, 1991 compliance filing, Kern River filed new Rate Schedules CH-1, SH-1, MO-1, and UP-1 to reflect the terms of its service agreements with the four shippers, making such terms available to others. Kern River's filing, which was made under section 4 of the NGA, did not contain any proposals which were inconsistent with the underlying service agreements.") (footnote omitted).

[155] *Columbia Gas Transmission Corp.*, 97 FERC ¶ 61,221 at 62,001-3. (2001).

manner" be filed. The Self Contained contracts have been filed with the Commission, and the Commission has found them just and reasonable and not unduly discriminatory subject to the requirement that they be included in Kern River's tariff and offered to all shippers on an open access basis. Because Kern River has not proposed to remove those rate schedules from its tariff, contracts for service consistent with those rate schedules cannot be material deviations from a *pro forma* service agreement for service under the separate KRF-1 rate schedule. Moreover, because service under the Self Contained Contracts is available on an open access basis, the Commission places little merit on Kern River's arguments related to the various roll-over provisions of the Self Contained Contracts.

120. While the Commission finds that it cannot approve Kern River's proposal in this section 5 proceeding to require shippers contracting for Period Two service to do so under Rate Schedule KRF-1, that finding is without prejudice to Kern River proposing under section 4 of the NGA to eliminate the rate schedules with the Self Contained Contracts pursuant to just and reasonable terms and conditions. In such a proceeding, the Commission may assess the effects of Kern River's proposals against the current status to determine whether Kern River's proposals are just and reasonable.

VI. Period Two Cost of Service and Rate Design Volumes

121. This section of the order deals with issues raised on exceptions concerning the cost of service and rate design volumes to be used in calculating Kern River's Period Two rates. In Opinion No. 486-D, the Commission clarified 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.[156] The Commission held that the only exception to this general approach to developing the 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."[157] The Commission stated that these circumstances include, for example, (1) the fact the Period Two rates must be designed to return the excess recovery of depreciation expenses existing at the end of Period One, and (2) the fact Kern River will have a 100 percent equity capital structure at the end of Period One.

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[156] Opinion No. 486-D, 129 FERC ¶ 61,162 at P 192-193.

[157] *Id*. P 193.

122. The participants have excepted to a number of the ALJ's rulings concerning the cost of service and rate design volumes to be used in calculating Kern River's Period Two rates. These include exceptions to the ID's findings: (1) Kern River had not justified the inclusion of the long term replacement costs of certain compressors in its Period Two levelized rate calculations; (2) the equity rate structure for Period Two should be 100 percent and thus debt issues regarding to Period Two are moot; (3) the Period Two rates should be designed on a 100 percent load factor; (4) Kern River had not justified a higher rate of return on equity than the 11.55 percent adopted by Opinion No. 486-C, (5) that the Shipper Parties and the Commission Trial Staff had not justified a lower ROE than 11.55 percent, and (6) the roll-in of Kern River's 2010 Expansion is not an issue to be considered in this docket. Each exception is discussed below, including a short background section and a summary of the 2011ID's findings and the parties' positions on exceptions.

A. Whether to Include the Replacement Cost of Compressors and General Plant in Kern River's Levelized Rate Methodology

123. In its original section 4 rate filing in this case, Kern River proposed to remove compressor engines and general plant from its levelized rates and collect depreciation costs for these plant items through traditional cost-of-service rates with straight-line depreciation. Kern River argued that the compressor engines and general are short-lived assets and are retired at a faster rate than Kern River's longer-lived transmission facilities. Kern River contended that requiring it to recover its investment in these short-lived assets over a substantially longer levelization period would require it to defer recovery of a substantial portion of associated depreciation until after the assets were retired. This would generate an increasing regulatory asset for recovery in the later years of the levelization period, and raise questions of intergenerational equity among ratepayers. Kern River also asserted that, because these assets are continuously retired and replaced, Kern River will require roughly the same amount of investment in such plant over time to support its operations. Kern River argued that the only difference between the levelized and straight-line depreciation mechanisms is the timing of the annual recoveries of the depreciation expense required for Kern River to recover its investment in compressor engines and general plant.

124. In Opinion Nos. 486 and 486-A, the Commission rejected Kern River's proposal, and required that the depreciation costs of these assets continue to be collected through levelized rates and not through traditional cost-of service rates

with straight-line depreciation.[158] The Commission explained that inclusion of these costs in the levelized rate methodology was part of the parties' original rate sharing agreement. While inclusion of the compressor engine and related plant costs in the levelized rate methodology may require Kern River to defer recovery of some of those costs, the levelized rate methodology allows it to treat such deferred recoveries as a regulatory asset. Therefore, such deferred recoveries are included in its rate base which allows it to earn a return on any deferred cost recovery. The Commission also pointed out that no ratepayer has raised a concern about intergenerational inequities on rehearing. The Commission held that the just and reasonable book depreciation rate for compressor engines is 9.92 percent and accepted Kern River's proposed rates for its general plant.[159]

125. Consistent with Opinion Nos. 486 and 486-A, Kern River's February 2011 Period Two compliance filing proposes to continue to levelize its recovery of its investment in compressors and general plant, using the depreciation rates approved by the Commission. In that filing, Kern River started with its actual unrecovered invested capital in compressors and general plant as of the close of the 2004 test period being used in this rate case. Kern River also projected the costs it projected it would incur to replace the compressors and general plant after the close of the test year 2004. As stated in its testimony for the Period Two hearing, Kern River "adjusted its cost of service to recover on a current basis in Period Two the incremental depreciation associated with replacements of compressor engines and general plant that occur during the remainder of Period One and Period Two."[160] Under its levelized methodology Kern River would recover any regulatory asset for those two categories existing at the end of Period One during Period Two, including any regulatory asset caused by the replacements it projected would be incurred after the 2004 test period.

126. At hearing the Shipper Parties and Staff opposed these projected additions of compressors to Kern River's rate base after the 2004 test period and the inclusion of the costs of those additions in Kern River's levelized rate methodology during Period Two.[161]

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[158] *See* Opinion No. 486, 117 FERC ¶ 61,077 at P 464-465, *order on reh'g,* Opinion No. 486-A, 123 FERC ¶ 61,050 at P 352, 358-359, 365.

[159] Opinion No. 486, 117 FERC ¶ 61,077 at P 464-467, P 489-490, n.735.

[160] Ex. KR-P2-1 at 2; Ex. KR-P2-24.

[161] ID, 135 FERC ¶ 63,003 at P 279, 708-716, 753-755.

127. The ID held that Kern River could recover during Period Two any regulatory asset for compressors and general plant remaining on its books at the end of Period One, but only the regulatory asset that existed at the end of the 2004 test period.[162] The ID therefore held that the projected replacements were inconsistent with the Commission's prior determination that Kern River could not include in its levelized cost of service any new compressor costs that were incurred after the end of the 2004 test period.[163] The ID did not address the projected replacements of general plant.

Briefs on and Opposing Exceptions

128. On exceptions Kern River opposes the ID's rulings and the Shipper Parties and the Commission's Trial Staff support them. Kern River bases its exception on two grounds. It first asserts that the ID failed to appreciate that Kern River's proposed Period Two opening rate base balances are correct as shown in Exhibit No. KR-P2-24. Kern River states that the Deferred Depreciation for Replacements account for the opening balances for Period Two is based on the actual 2004 Test Period CE/GP balances, the approved CE/GP book deprecation rates, and the replacement intervals established by Kern River's actual replacement rates through the end of the test period. It states that Kern River's calculations for Depreciation Deferred for Replacements thus rely on the approved 2004 test year book depreciation rates and replacement intervals that underlie its book depreciation rates. Kern River asserts that determining the correct regulatory liability balance as the start of Period Two requires recognition of the Depreciated Deferred Replacements during the remainder of Period One. It concludes the ID's holding that Depreciation for Deferred Replacements should be excluded as a post-2004 cost is incorrect. Kern River states that if not corrected, this will result in its having a greater regulatory liability at the beginning of Period Two than is warranted given the structure of its levelized rate methodology.[164]

129. Kern River's second assertion is that the ID incorrectly excluded Depreciation for Deferred Replacements that it is projected to incur in Period Two. It asserts that the ID improperly considered these Deferred Replacement Depreciation Costs that are added to Period Two to be new costs that are incurred after 2004. It asserts that this is incorrect because its levelized rate methodology

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[162] *Id*. P 1112-1158.

[163] *Id.* P 1112.

[164] Kern River Brief on Ex. at 12-14.

requires that all of its initial capital costs be recovered by end of Period Two. Kern River asserts that in order to do this it properly extrapolated the additional deferred replacement costs it would incur through the end of Period Two, that it properly built these into its levelized rate methodology, and that its extrapolations are uncontested. It further argues that no party has disputed the levelization calculations to derived the Period Two rates properly include these Period Two depreciation costs. It again asserts that unless the extrapolated expenses are included in its levelized rates, it will not recover all of its remaining capital investment during Period Two. Kern River thus concludes that the projected replacement costs and any resulting regulatory assets are properly a transitional element between Period One and Period Two.[165] In any event, the Shipper Parties, Trial Staff, and the ID have treated the projected replacement costs for compressors and general plant inconsistently by excluding the former for its levelized rate methodology, but including the latter.

130. The Shipper Parties and Trial Staff argue that the Commission's prior orders provide that new costs means any rate base increases that are incurred after the close of the 2004 test period. They assert that the record here is clear that Kern River has included in its levelized rate methodology extrapolated or projected replacement costs for its compressors that will be incurred after the close of the 2004 test period. They assert that this violates the Commission's explicit direction that no new costs incurred after close of the 2004 test period cost -of-service are to be included from Kern River's levelized methodology. They further assert that Kern River's extrapolations were in fact disputed as being based on unknown future replacement rates and the projected costs of those units. They also argue that Kern River's argument that it will not recover some of its costs is not credible.[166] In addition BP asserts that (1) Kern River's adjustments are inconsistent with the original regulatory bargain between the Shipper Parties and Kern River, and (2) results in an asymmetrical relationship between Kern River and its shippers.[167]

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[165] Kern River Brief on Ex. at 12-18 (citing ID, 135 FERC ¶61,003 at P 1127).

[166] BP Brief op. Ex. at 19-23, 24-25; Trial Staff Brief op. Ex. at 8-10; Morgan Stanley Brief op. Ex. at 4-7; RCG Brief op. Ex. at 6-19; Nevada Power Brief op. Ex. at 4-7; Southern California Generation Coalition Brief op. Ex. at 5-6.

[167] BP Brief op. Ex. at 16-19, 23-24.

Commission Determination

131. In Opinion Nos. 486 and 486-A, the Commission required Kern River to retain the levelized rate methodology for the amortization of its investment in compressors and general plant.[168] The Commission also approved a book depreciation rate for compressors of 9.92 percent and accepted Kern River's proposed book depreciation rates for general plant.[169] The Commission held that, to the extent the levelized rate methodology requires Kern River to defer recovery of its invested capital in these assets, it may treat such deferred recoveries as a regulatory asset. Such a regulatory asset may be included in its rate base which allows it to earn a return on any deferred cost recovery. The only issue before us here is whether Kern River's Period Two compliance filing properly followed these principles. For the reasons discussed below, the Commission affirms the ALJ's holding that Kern River improperly included in its calculations the costs it projected it would incur after the end of the 2004 test period to replace compressors which are retired between the November 1, 2004 effective date of the Period One rates proposed in this rates case and the start of Period Two on October 1, 2004.

132. Period Two plant balances are derived in part from the plant balances used to design Kern River's Period One rates and therefore this order includes a short reprise of those issues in Period One. Kern River's support for its 2004 rate filing contains a schedule showing the rate base for its compressors as adjusted for the end of the 2004 test period. This schedule is separate from the rest of its transmission plant because the useful life of compressors is shorter than the rest of Kern River's transmission assets.[170]

133. The work papers attached to Kern River's January 29, 2010 compliance filing for its Period One rates stated the regulatory asset for its compressors was $22,935,942 on October 31, 2004, and the regulatory asset for general plant was $22,178,750 for the same date. The Workpapers state for each compressor the cost of the compressor and the date of installation, and thus the dollar amount that

[168] *See* Opinion No. 486, 117 FERC ¶ 61,077 at P 469-478, *order on reh'g,* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 366-368.

[169] Opinion No. 486, 117 FERC ¶ 61,077 at P 464-467, 489-490, n.735.

[170] *See* Kern River Gas Transmission Co., Docket No. RP04-274-000 (45 Day Update) Work Papers Filed December 15, 2004 (45 Day Update) at Statement A, page 1. *See also* Opinion No. 486, 117 FERC ¶ 61,077 at P 56.

is added to Kern River's gross plant at the time of acquisition. The Workpapers also state for each compressor the amount of accrued depreciation and the net plant for that compressor. Since compressors are being replaced periodically at the same site, as each compressor is replaced Kern River's books are adjusted to reflect the salvage value of that compressor as it is replaced. However, because accrued regulatory depreciation for such a compressor is less than book depreciation at the time the unit is replaced, Kern River's books will normally reflect a regulatory asset for each compressor that carries forward even after the units have been replaced. As the Workpapers state, this ongoing difference between book and regulatory depreciation, equaling an approximately $23 million regulatory asset on October 31, 2004, is the difference between revenue from regulatory depreciation under the levelized rate methodology and Kern River's book depreciation. [171] This reflects the difference between total revenue that would have been generated by traditional rate making methodologies and the revenue actually derived from Kern River's levelized rate methodology through the date of Kern River's 2004 rate filing.

134. Under Kern River's levelized rate methodology, compressor regulatory assets that are not recovered in Period One are to be recovered in Period Two.[172] However, this became a matter of dispute in the initial phases of the Period Two hearing with some parties arguing that if Kern River did not recover in Period One the entire compressor regulatory asset accumulated in Period One, Kern River could not recover that regulatory asset in Period Two. Kern River therefore filed a motion for clarification in this regard. On December 6, 2010, the Commission issued an order stating that "[i[f at the start of Period Two, the cumulative allowance for depreciation of compressors included in its rates is projected to be less than the straight-line depreciation on its books, Kern River may treat the difference as a regulatory asset and add it to the starting Period Two rate base for purposes of calculating the levelized Period Two rates."[173] The Commission also

[171] *See* Kern River Gas Transmission Co., Docket No. RP04-272-021, January 29, 2010, Period One Compliance Filing (January 2010 Compliance Filing), Workpapers Tab at 4 Lines 12 and 11. The regulatory asset is not stated on the worksheet for each compressor, but is summarized Tab A, Schedule 16.

[172] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 371-375.

[173] *Kern River Gas Transmission Co.*, 133 FERC ¶ 61,199, at P 12. (2010 Clarification Order) (2010).

explained why some language in its prior orders did not require a different result.[174]

135. The 2010 Clarification Order continued:

> The Commission is not addressing here whether the amount of the regulatory asset Kern River proposes to add to its starting Period Two rate base is correct. This is a matter that can be explored at hearing due to the technical nature of the issue. However, the Commission emphasizes that Kern River's Period Two rates must be based on the 2004 cost of service used to design its Period One rates unless Opinion No. 486-D specifically stated otherwise. The Commission stated it "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." Moreover, as correctly stated in Calpine's protest, if Kern River wishes to recover costs that were not included in the 2004 test period for its Period One rates, it must file a new rate case. Opinion No. 486-D states:
>
>> 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.
>
> The same paragraph in Opinion No. 486-D makes clear that the Commission generally does not permit a pipeline to file a limited section 4 proceeding to change the rates for some groups of customers, but not others. Thus, while the Commission is not addressing the particulars of this issue here, it holds that Kern River may not include in its regulatory assets new compressor costs that it has incurred after the 2004 test period. If Kern River desires to

[174] *Id*. P 13.

> include such new costs, not incurred as of year-end 2004, in either its Period One or Period Two rates, it may do so. <u>However, as with any other new cost Kern River may desire to include in its rates, Kern River must file a new general section four rate case covering all of its cost of service factors, including the revenues obtained in a new test period.</u>[175]

136. The first issue to be considered here is whether Kern River properly adjusted its rate base, including that for the compressors and general plant, to reflect the proper balances at the beginning of Period Two. This analysis starts with the amount of the compressor and general plant balances and regulatory assets as of October 31, 2004, as stated on the 45 Day Update and as ultimately included in the rates contained in Kern River's Period One rate compliance filing. Under Kern River's levelized rate methodology those balances must then be adjusted to reflect the operation of the levelized model between the end of the 2004 test period and the date that the each of the Period Two rates would become effective. The plant balances on Kern River's books would decline and the regulatory asset generated by these short lived assets would be recovered over the balance of the Period One rates and over the Period Two rates based on the amounts in Kern River's Period One compliance filing.

137. Regarding the compressor and general plant replacement issue now before the Commission, if Exhibit No. KR-P2-24 as included in Kern River's Period Two compliance filing only reflected changes in the plant balances and the regulatory assets related to the compressors and general plant on its books as of October 31, 2004 (the end of the 2004 test period) through the effective date of each of the Period Two contract groups, the cited exhibit would reflect the correct methodology and would be acceptable as it stands. Kern River would thereafter recover any remaining depreciation and regulatory asset for the compressors and general plant in Period Two under its original levelized rate methodology. Under its levelized rate methodology Kern River would recover its costs through its amortization of the regulatory assets currently on its books over a longer period of time than it would if it were using a traditional rate making methodology.

138. However, Exhibit No. KR-P2-24 is not so limited. That exhibit clearly reflects the additional investment in compressors and general plant that Kern River would be making from October 31, 2004 through 2024 and the stable level of gross plant (approximately $30 million) that would occur through that date, the

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[175] *Id*. P 11 (internal citations omitted; emphasis added).

relatively large net plant that would result at the end of that period (some $19.8 million), and the large regulatory asset that would result (some $41.1 million) at the end of Period Two.[176] These numbers reflect Kern River's own testimony, which stated that Kern River "adjusted its cost of service to recover on a current basis in Period Two the incremental depreciation associated with replacements of compressor engines and general plant that occur during the remained of Period One and Period Two."[177] This language should therefore be construed as reflecting cost for replacement of compressors and general plant that will occur after the end of the 2004 test period, just as is stated in Exhibit No. KR-P2-24. It was perhaps for this reason that Kern River argued at hearing that the Commission's prior orders only address "new costs" for replacement compressors and general plant. This would be those exceeding the unit replacement costs and the replacement rate of the units included in its 2004 cost-of-service[178] and that were reflected on the 45 Day Update.

139. While this concept of new costs is not clearly addressed in Kern River's Brief on Exceptions, it appears to be reflected in Kern River's statements that it properly <u>extrapolated</u> its existing depreciation rates and replacement costs for compressors and general plant in arriving at the Depreciation for Deferred Replacements it would recover in its Period Two rates. The Shipper Parties and Trial Staff assert that this extrapolation reflects new costs for replacement units that will be acquired after the 2004 test period and therefore should be excluded from the rate base and opening balances that will underpin the Period Two rates.

140. Based on the record here the Commission clarifies that the latter interpretation is the correct one. In reviewing the difference between the levelized rate and traditional rate methodologies, Opinion No. 486-D states:

> 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

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[176] Ex. No. KR-P2-24 at 1 of 2.

[177] Ex. KR-P2-1.

[178] ID, 135 FERC ¶ 63,003 at P 1125-1127.

> 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.[179]

Opinion No. 486-D then continued

> However, as Kern River itself recognizes elsewhere in its rehearing request, "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." 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. . . .[180]

141. The fact that under traditional rates the rates remain in effect regardless of declines in the rate base until replaced through a new rate case is the core of the issue here. The record establishes that Kern River replaces its compressors on average of every three to four years for approximately $9.1 million in 2004 dollars.[181] Under a traditional rate design this amount is added to the rate base. As long as the existing depreciation rates remain effect, those assets would generate long term cash flow that would enable the pipeline to recover future costs even if the rate base of its historical costs has declined. For example, assuming the average depreciation rate is $3.03 million over three years, this amount of revenue (and cash) would continue to be generated and will recover replacement costs even if the original $9.1 million on which it was based has been fully recovered in earlier accounting periods. This is true even though under traditional rates a pipeline is not permitted to include in its rates future costs that fall outside the 21 month test period under the Commission's test period regulations.[182]

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[179] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 156.

[180] *Id.* P 157 (internal citations omitted).

[181] ID, 135 FERC ¶ 63,003 at P 705.

[182] *See* 18 C.F.R. § 154.303(a)(4) (2011).

142. In contrast, because levelized rates involve a declining rate base, the resulting rate reflects the decline of the rate base items over their asset life without regard to future replacements, and therefore in practical terms will not recover those costs. Thus a levelized rate will not generate cash flows equal to the cost of future replacements absent a subsequent rate filing that reflects the actual dollar value of the replacement costs added to the pipelines rate base when such a subsequent rate filing is made. To overcome this accounting limitation Kern River first attempted to convert its levelized compressor rates to traditional rates with the expectation of a continuing cash flow that does not reflect the decline of the compressor rate base contained in its 2004 cost-of-service.[183] As stated in Opinion No. 486:

> Kern River argues that certain compressor engines and general plant should be removed from the levelized methodology because they constitute short-lived assets and are retired at a faster rate than Kern River's longer-lived transmission facilities. Therefore, Kern River argues that applying the levelized depreciation rates to these short-lived assets results in their retirement and replacement long before Kern River can recoup its capital investment in such facilities.[184]

The Commission rejected this approach, stating:

> The Commission understands Kern River's argument that this levelized methodology may not be uniquely suited for the precise recovery of all depreciation for all facilities, but this is the method that Kern River originally proposed, and the Commission accepted, and that all parties have relied upon. The Commission will not now permit Kern River to continue its preferred method of depreciation for most of its assets while at the same time consider its argument that it might benefit to a greater extent if certain facilities were excluded from the levelized methodology and treated to a more advantageous depreciation recovery methodology.[185]

What Kern River seeks here is the same financial result it would achieve through the use of a traditional rate design by building the replacement costs it has or will

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[183] *E.g.* Opinion No. 486-D, 133 FERC ¶ 61,162 at P 160.

[184] Opinion No. 486, 117 FERC ¶ 61,077 at P 56.

[185] *Id*. P 57.

incur after 2004 into its levelized rate methodology. This would raise the amount of the depreciation to be recovered during Period Two, including the higher level of compressor regulatory assets that would accumulate by the end of Period One. Kern River's brief on exceptions is opaque on this central point, but Exhibit No. KR-P2-24 speaks for itself. Thus Kern River may not include the replacement costs it has projected it will incur beyond the 2004 test period for either the compressors or for general plant. This will reduce the regulatory asset available to Kern River at the beginning of Period Two, but this is a function of the levelized rate methodology initially agreed to by Kern River and its shippers.

143. The Commission therefore affirms that if Kern River desires to include replacement costs incurred after the close of the 2004 test period in its levelized rate methodology, it must file a new rate case, or a series of rate cases. The accounting protocol for filing a new rate case to recover these compressor costs is illustrated by the accounting sheets in the 45 Day Update documenting the compressor rate base, including the replacement dates, the book and regulatory cost involved through the October 31, 2004 end of the test period.[186] Kern River appears to have calculated separately the regulatory asset that existed on the date of the analysis for all the compressors that had already been included in its rate base at the end of the test period and that were proposed to be amortized through its Period One rates.[187] Thus in any new rate case Kern River would perform the same analysis based on the verified book costs of any compressor replacement costs incurred after 2004. It would then adjust its levelized rate methodology to reflect the portion of those additional costs that remained in its rate base at the end of the test period used to support any future section 4 rate case. The regulatory depreciation for the assets acquired after 2004 would be included in rates of any new section 4 rate filing on a going forward basis, as would any regulatory asset accrued from the use of that regulatory depreciation on a going forward basis from the end of the new test period. Therefore one of Kern River's considerations in deciding whether to file a new section 4 rate case is that it will not be permitted to recover in its prospective rates the regulatory depreciation for past periods for any additional compressors it acquired between the end of the 2004 test period and the date that it filed a new rate case, for example January 1, 2012. Moreover, since

[186] *See* 45 Day Update, Attachment A, Schedule 7.

[187] As sheets for each compressor site indicate, some of the compressors were completely retired for purposes of standard book accounting. However, in some cases a net basis remained because the regulatory depreciation rate was so much lower than the standard book depreciation rate.

there might otherwise be a difference between the two under Kern River's levelized rate methodology that would otherwise generate a regulatory asset, Kern River may not include that difference in the rates it files for a new section 4 rate case.

144. The difference in cash flow between the two rate design methodologies for short lived assets such as compressors notwithstanding, the 2010 Clarification Order was correct that if Kern River wishes to recover compressor costs incurred after the end of the 2004 test period, it must do so through a new section 4 rate filing. This requirement is no different than that for traditional rates, which rate methodology also precludes additions to rate base outside the test period because of uncertainties regarding the costs that will actually be incurred.[188] Kern River's effort to include future replacement costs for compressors and general plant items violates this fundamental rate making principle. It would permit Kern River to avoid what Kern River may perceive as the negative results of such a filing, e.g. the requirement to roll in the cost of its 2010 Expansion. But as the 2010 Clarification Order makes clear, the pipeline must take the bitter with the sweet and make the relevant financial choices.

145. At bottom, in any section 4 rate filing the rate base is a snap shot taken at the end of the base year, and is usually updated to reflect known and measurable events during an additional nine months.[189] The difference between levelized rates and traditional rates is a matter of rate design and the time frame over which the costs are recovered, not how the rate base or the operating costs are defined. The timing differences in rate design does not modify the principles of how to construct the cost-of-service that ultimately underpins a given rate methodology. This result may seem harsh, but the basic fact is that Kern River is proposing here to change its levelized rate methodology from that used to design its levelized rates for the first time since it adopted that methodology. As discussed, compressor costs have a different average useful life, and therefore a different book depreciation life, than the assets with longer like such as the pipe through which the gas flows or building structures that support the system.[190] This

[188] *See, e.g., Entergy Services, Inc.*, 120 FERC ¶ 61,020, at P 32 (2007); *see also City of New Orleans, Louisiana v. FERC*, 67 F.3d 947, 955 (D.C. Cir 1995).

[189] *See* 18 C.F.R. § 154.303(a)(4) (2011).

[190] *See* 45 Day Update, Statement A, Page 1 of 3, line 12; Statement B, Page 2 of 3, lines 2 and 3; and Schedule C-1. lines 11 and 12 (FERC Acct. 367 and FERC Acct. 368). In 2004 the regulatory depreciation rate for Kern River's compressors ranged from 2.50 to 1.97 percent. *Id.*, Statement A.

difference in the book lives and depreciation rates is Kern River's risk under its levelized rate methodology.

146. Moreover, the Commission's review indicates that there is no place in this record that Kern River states that the replacement methodology it advances here was ever included in the original design of its levelized methodology it applied to its original construction or any of the subsequent expansions. If the replacement methodology it proposes here had been part of that initial levelized methodology, the instant debate would not be before us. Rather, what would be involved is the update of the replacement rates and costs as part of standard test period analysis. This is the argument Kern River advances here, but at this point it is untimely. Kern River's efforts to change the methodology for recovering its compressor costs are inconsistent with its original bargain with its shippers, as were its prior efforts in this proceeding to adopt a traditional rate methodology for the recovery of its compressor costs.[191] It must be rejected for the same reason. Given this fundamental conclusion here, it is not necessary to reach any arguments whether Kern River properly projected the replacement costs rejected here, or whether any replacement costs Kern River desires to add to its Period Rates are a transitional issue between Period One to Period Two.[192] The ID is affirmed.

B. Capital Structure

147. In Opinion No. 486-D, the Commission held that Kern River would be permitted to adjust the cost of service used in this proceeding to calculate its Period One rates in order to use a 100 percent equity structure in its Period Two rates.[193] The levelized rate structure approved in Kern River's original certificate proceeding is intended to permit Kern River to recover all its debt capital during Period One. Accordingly, 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.[194] In Opinion No. 486-A, the Commission stated that, if Kern River refinances its debt and the debt

[191] *See* Opinion No. 486, 117 FERC ¶ 61,077 at P 464-65, *order on reh'g*, Opinion No. 486-A, 123 FERC ¶ 61,050 at P 352, 358-359, 365.

[192] *See* Opinion No. 486-D, 133 FERC ¶ 61,162 at P 194; *Cf.* BP Energy Company Brief Op. Ex. at 23-25.

[193] Opinion No. 486-D, 129 FERC ¶ 61,062 at P 195.

[194] August 1992 Order, 60 FERC at 61,437.

is not extinguished before the implementation of the Period Two rates, the level of the Period Two rate may be adjusted to reflect any benefits to shippers from such action.[195] However, in Opinion No. 486-D, the Commission stated that no such refinancing occurred during the test period in this rate case, and therefore the Period Two rates established in this proceeding should reflect a 100 percent equity capital structure.

148. At the hearing, BP, Morgan Stanley, and Trial Staff pointed out the Kern River is not currently scheduled to pay off its entire aggregate debt until 2018, although Period One ends for some customer groups before that date. Therefore, they contended that a 100 percent equity capital structure should not be reflected in the Period Two rates of any customer group until that date. The ID concluded that the issue of the 100 percent equity structure was moot because the Commission held in Opinion No. 486-D that Kern River could utilize a 100 percent equity structure.[196] The ID therefore also held that any issues relating to a Period Two debt structure were also moot.[197]

Briefs on and Opposing Exceptions

149. On exceptions, the BP, Morgan Stanley, and Trial Staff oppose the ID’s conclusion regarding the 100 percent equity structure while Kern River supports it. The parties arguing that the 100 percent equity capital structure should be delayed until all Period One contracts expire and all Period One debt is paid would apply the weighted cost of capital at the end of the 2004 test period to both the Period One and Period Two rates until all of the Period One contracts expired. They assert that any 100 percent equity capital structure would be a hypothetical until that point because Kern River will still have Period One debt outstanding at the time the first Period Two rates become effective. They further assert that the Commission has held that that Period One ends when all of the Kern River’s existing debt has been paid. Trial Staff and Morgan Stanley assert that use of a 100 percent equity structure would be highly unusual under Commission precedent.[198] They therefore conclude that the Commission intended that Kern

[195] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 46.

[196] *Id*. P 331 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at 195).

[197] *Id*. P 332.

[198] Trial Staff Brief on Ex. at 21-25; Morgan Stanley Brief on. Ex. at 17-20.

River have a 100 percent capital structure only after all of the Period One contracts expire and all Period One debt is paid.

150. BP, Morgan Stanley, and Trial Staff further state that the Commission has held that shippers should receive the benefit of any debt that Kern River has outstanding in Period Two. They assert that if there is any Period One debt left in Kern River's capital structure at the beginning of Period Two, the Period Two rates must reflect that debt. They thus conclude that Kern River's existing debt to equity ratio should apply to both the Period One and Period Two rates until all Period One debt is retired at the end of Period One. BP, Trial Staff and Morgan Stanley therefore conclude that a 100 percent equity capital structure should not be adopted until it is clear that Kern River does not intend to roll over any of its existing debt to Period Two.[199]

Commission Determination

151. The Commission has consistently held that Kern River's Period Two rates will be designed using a 100 percent equity structure assuming that Kern River does not refinance its debt. This holding is grounded in the Commission's August 1992 Order in the optional expedited certificate proceeding that granted Kern River's request to clarify that its Period Two rates could be designed using a 100 percent equity structure.[200]

152. Under the rate design principles approved in Kern River's original certificate proceedings, its levelized Period One rates are designed to enable Kern River to recover the approximately 70 percent of its invested capital which was financed by debt. Thus, by the end of each shipper's Period One contract, that shipper will have paid its allocated share of that 70 percent of Kern River's invested capital, regardless of whether Kern River has actually paid off that date by the expiration of the shipper's Period One contract. It follows that each customer's Period Two rates should reflect its payment of its share of the 70 percent of Kern River's invested capital from the date Period Two commences for that customer, with the result that the Period Two rates for that customer will reflect a 100 percent equity capital structure.

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[199] BP Brief on Ex. at 26-27; Trial Brief on Ex. at 25.

[200] *See* Opinion No. 486-D, 133 FERC ¶ 61,162 at P 161; *see also* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 142-143.

153. As early as Opinion No. 486, the Commission recognized that there are separate capital structures for each group of customers embedded in Kern River's levelization model. The Commission stated:

> Kern River has developed individual rates based upon separately calculated equity rate base amounts for each customer class. The calculations are based upon the same levelization model but differ in that they reflect the customer's actual investment, debt, and deferral. Parties argue that the same constant or uniform capital structure should be applied to all customers regardless of customer contracts or class. Kern River points out that the impact of these recommendations generally results in increased rates or a cost shift from the Expansion shippers to the Rolled-in customers. . . . We find that the record evidence demonstrates that Kern River's use of average capital structure in each levelization model or for each customer class is appropriate. Use of the same capital structure for all customers would alter each customer's cost responsibility under the existing contract and levelization model previously agreed to and adopted by the Commission. Kern River has developed rates for each customer class under levelization models that reflect the deferrals associated with the particular levelization model.[201]

As Kern River pointed out at hearing, delaying the implementation of the 100 percent equity capital structure until all the Period One contracts expire would result in just this type of cost shifting.[202]

154. On rehearing of Opinion No. 486, BP contended that the Commission's refusal to require Kern River to use the same actual capital structure for all customer groups resulted in the use of a hypothetical capital, contrary to Commission policy. In Opinion 486-A, the Commission rejected this contention, stating:

> In this case, however, the pipeline is not using traditional cost-of-service ratemaking and the principles concerning the use of a hypothetical capital structure in traditional cost-of-service ratemaking do not apply. In this case, the Commission has approved

[201] Opinion No. 486, 117 FERC ¶ 61,077 at P 119.

[202] ID, 135 FERC ¶ 63,003 at P 833-835.

> the recovery of the debt-financed portion of rate base over the terms of the shippers' contracts through the use of levelized rates and the deferral of the recovery of the equity-financed portion of rate base. All of Kern River's depreciation recovery during Period One is devoted to retiring its debt.[203]

In that portion of Opinion 486-A, the Commission stated that recovery would occur over the terms of the shipper's contracts. In using the plural tense the Commission implicitly recognized that the recovery of the debt was tied to a series of contracts, which is consistent with its prior recognition that Period One rates reflect each customer's actual investment, debt, and deferral. Opinion No. 486-A did not say that Period Two would begin when all of the Period One contracts had expired, which would be an irrational statement given that the structure of the Period One contracts, the Period Two contracts and the fact that the rates become effective at different times.

155. Opinion No. 486-D reiterated the fundamental conclusion that standard policies regarding the equity component of a capital structure do not apply to Kern River's Period Two rates, stating:

> 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. Therefore, the Commission ordinarily would not approve the use of a 100 percent equity capital structure. However, as previously discussed, the 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.[204]

Proposals to apply Kern River's current capital structure to Period Two rates until such time as all of the Period One contracts have expired seek the same result as a hypothetical capital structure. Adopting any such proposal would reduce the amount of the equity component applicable to the earlier Period Two rates by introducing a weighted capital structure including a debt component.

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[203] *Id.* P 146.

[204] Opinion No. 486-D, 133 FERC ¶ 61,162 at 161 (internal citations omitted).

156. However, as discussed earlier, Kern River's levelized methodology contemplates a gradual transition to an increasingly 100 percent equity structure. As each Period One contract expires, the shippers to that contract have paid at the point for 70 percent of the rate base apportioned to their contracts and have also amortized the debt attributed to the financing of that portion of Kern River's rate base.[205] As 70 percent of the shipper's portion of Kern River's rate base is amortized at the end of a Period One contract, Kern River enters a commensurate part of its 100 percent equity phase because the debt related to that particular portion of its rate base has been retired. In contrast, applying a weighted cost of capital to such a portion of Kern River's assets would deprive Kern River of a portion of the equity return it reasonably expects to earn in Period Two under the original bargain between Kern River and its shippers. Thus the ID's conclusion that the issue of the 100 percent equity structure is moot was correct in that each Period Two contract has a 100 percent equity capital structure when that Period Two contract becomes effective.

157. Given the previous conclusion that a 100 percent equity structure is appropriate, the ID was correct to conclude that there is no cost of debt issue for Period Two rates. As the previous analysis explains, Period One rates are based on a Period One rate base and a Period One capital structure that reflects each customer's actual investment, capital structure, and deferral. Likewise, Period Two rates will be based on each customer's actual investment, equity, and deferral during Period Two, including any debt that is attributable to that specific Period Two contract through refinancing. As such, arguments that Period One debt should apply to Period Two rates are inconsistent with the temporal structure of Kern River's levelized rate methodology. The fact that there are Period One rates remaining in effect for some customer groups as the Period Two rates come on line for other customer groups is irrelevant for purposes of designing the Period Two rates since the latter are tied the individual customer's actual investment, equity, and deferrals at that time.

158. In Opinion No. 486-B the Commission granted BP's request to clarify that if Kern River refinances its debt before the implementation of Period Two rates, the Period Two rates must be adjusted to reflect the benefit to shippers of that refinancing. The Commission explained:

[205] ID, 135 FERC ¶ 63,033 at P 407, 829, 835, 1115.

> In Opinion No. 486-A, the Commission, in discussing the composition of Kern River's Period Two rates, determined that the Period Two rates must be filed with the effective dates linked to the expiration of the 10 or 15 year contracts currently held by Kern River's shippers, and that the Period Two rates must be based upon no more than 30 percent of Kern River's current rate base, which is an amount corresponding to the amount of equity under Kern River's capital structure. In addition to this finding, the Commission also stated that
>
>> [I]f Kern River <u>refinances</u> its debt, and the debt, therefore, is not extinguished before the implementation of the Period Two rates, the level of the Period Two rates may be adjusted to reflect any benefits to shippers from such action but not any detriment to shippers.[206]

However, as the Commission held in Opinion No. 486-D, no such refinancing occurred during the test period in this rate case, and therefore the Period Two rates established in this proceeding should reflect a 100 percent equity capital structure. The ID's conclusion on debt issues is affirmed.

C. Rate Design Volumes

159. 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 through Opinion No. 486-D, the Commission held that the 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. Accordingly, the Commission held that Kern River's Period One rates must be designed based on its actual Period One billing determinants.

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[206] Opinion No. 486-B, 126 FERC ¶ 61,034 at P 172 (internal citations omitted) (emphasis added).

160. Despite the Commission's holdings concerning the volumes to be used in designing Kern River's Period One rates, Kern River's Period Two compliance filing proposed a design its Period Two rates based on 95 percent of its design capacity, rather than its actual Period One billing determinants. Kern River contended that this was appropriate because its Period One contracts expire at the end of Period One and it does not currently have contracts with any shippers for Period Two. The other parties contended that the Period Two rates should be designed based on the same actual 2004 test period billing determinants as the Period One rates.

161. In Opinion No. 486-D, the Commission stated that 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. Therefore, the Commission stated that 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.[207]

Initial Decision and Briefs on and Opposing Exceptions

162. The Shipper Parties and the Trial Staff opposed the use of 95 percent load factor rate design factor at hearing. The ID held that Kern River had not justified the use of a 95 percent load factor rate design.[208] In reaching this conclusion, the ID found, relying on the testimony of Morgan Stanley and other Shipper Parties, that Kern River's load factor was consistently in excess of 100 percent for the years 2004 – 2009 as well as 2010. The ID thus agreed with Trial Staff and the Shipper Parties that there was no reason not to use the same actual billing determinants from the 2004 test period previously adopted by the Commission for Period One.[209] In doing so, the ID thereby rejected Kern River's arguments that increased take-away pipeline capacity in the Rocky Mountain producing basin, the narrowing of basis differentials, and changes in supply had weakened its competitive position in that time frame.

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[207] ID, 135 FERC ¶ 63,033 at P 1033 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P-198).

[208] *Id.* P 1027-1036.

[209] ID, 135 FERC ¶ 63,033 at P 1035-36.

163. On exceptions ID Kern River opposes the ID's holding on this issue,[210] while several of the Shipper Parties[211] support it. Their dispute turns on different perceptions of the current competitive and gas supply environment and whether Kern River's contract risk for its Period Two capacity supports the use of 95 percent rather than a 100 percent load factor to design its Period Two rates.[212]

Commission Determination

164. Because the 2010 evidence on the load factor issue covers dates outside the 2004 test period, the threshold matter is whether the load factor issue is an exception to the statement in Opinion No. 486-D that "the Commission continues to find that the starting point for calculating the Period Two rates in this proceeding must be the cost of service the Commission has already determined for Period One based upon the 2004 test year data used in this section 4 rate case."[213]

165. On review, the Commission again concludes that using evidence outside the scope of the 2004 test period would permit Kern River to address one element of its Period Two rate design using more recent information without having its other Period Two rate design elements subject to the same scrutiny and thus without the risk of adjustments unfavorable to Kern River. As Opinion No. 486-D reiterated, 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.[214] This rule should control here.

166. Given the previous conclusion, Kern River's Period Two rates must be designed based on the same actual 2004 test period billing determinants as used to design Kern River's Period One rate, because Kern River provided no evidence of

[210] Kern River Brief op. Ex. at 25-28.

[211] BP Brief op. Ex. at 4-15; Calpine Brief op. Ex. at 25-28; Morgan Stanley Brief op. Ex. at 10-12; Nevada Power Brief op. Ex. at 7; RCG Brief op. Ex. at 24-27.

[212] As noted, this period ranges from September 30, 2011 through 2018.

[213] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 193 (emphasis added).

[214] *Id*. P 193.

why this should change based on the 2004 test period data. The fact that Kern River's Period One contracts will expire before Period Two begins does not distinguish Kern River's situation from that of any other pipeline that has existing contracts expiring over a several year period. Under basic test period concepts and its regulations, the Commission designs rates using historical data from a twelve month test period, as adjusted for known and measurable changes occurring in the subsequent nine months.[215] The Commission does not look beyond this twenty-one month test period to consider speculative matters that might affect throughput or the pipeline's billing determinants. Therefore regardless of the time frame chosen for the analysis, Kern River's billing determinants would be designed using the throughput that actually occurred in a test period and not be based on projected changes to that historical throughput.

167. Therefore the fact some of Kern River's contracts might expire in a future period, and that some of its capacity may not be resold, is irrelevant to determining the billing determinants used to design new rates if those changes occur after the end of the nine month adjustment period and after the rates that are under review become effective.[216] In this regard, Kern River's only distinction from other gas pipelines is that Kern River has the advantage of contracting its expiring contracts at significantly lower rates in addition to contracting under its existing recourse rates.[217] While Kern River repetitively states that at this point it has no Period Two contracts, this is a truism that only establishes that Kern River has a series of contracts expiring between September 30, 2011 and 2018, and will have to contract that capacity as the contracts expire. As BP states, if there is an increased risk associated with contract expirations, this goes to the equity cost of capital, not throughput determinations addressing the use of a 100 percent load factor.[218]

168. However, the Commission notes that Opinion No. 486-D states:

> 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

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[215] *See* 18 C.F.R. § 154.303(a)(1) and (2).

[216] 18 C.F.R. § 154.303(a)(3) and (4).

[217] *See Kern River Gas Transmission Co.*, 135 FERC ¶ 61,179 at P 27-29.

[218] BP Brief op. Ex. at 14-15.

> 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.[219]

The record indicates that the parties and the ID construed the cited language as holding that the load factor issue might be a rate design element that is uniquely related to the expiration of Kern River's Period One contracts. This is reflected in the use of evidence far outside the 2004 test period to analyze the contracting risk Kern River faces over the next several years as its Period One contracts expire. The Commission has explained why this interpretation of Opinion No. 486-D is mistaken and why the analysis would normally stop here. However, given the parties' misperception, the Commission will review the updated evidence to determine under these limited circumstances whether the parties' use of updated information would warrant a different conclusion than that grounded in the 2004 record. In that regard, all parties recognize that Kern River cannot design its rates based on less than 95 percent of its design capacity because of the condition in its original certificate.[220] Thus the issue they address is whether the Period Two rates should be designed based on this floor or whether the Period Two rates will be designed using Kern River's actual 2004 test period billing determinants embedded in Kern River's Period One rate design.

169. Both Kern River and the Shipper Parties updated the instant record with market information for the period 2004-2009. Kern River makes three core arguments to support reducing the load factor for the Period Two rates to 95 percent. First, it asserts that it faces increased competition in the California market, particularly from the 1.5 Bcf/d Ruby Pipeline (Ruby) to northern California. Second, Kern River argues that increases in take-away capacity to markets east of the Rocky Mountain gas producing fields has provided gas producers with access to more markets, thereby increasing the prices they can obtain. This, Kern River asserts, has lowered the value of Kern River's transportation capacity below the level of its projected Period Two rates. Third, Kern River claims that changes in supply relationships have increased the risk of inadequate supply for pipelines serving the Rocky Mountain producing areas and that those supplies may be displaced by supplies from other areas. In addition, it argues that historical increases in demand for gas in its consuming markets slowed

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[219] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 198.

[220] *E.g.* ID, 135 FERC ¶ 63,033 at P 1035.

in 2008 and 2009.[221] For these reasons Kern River concludes that the historical throughput it transported under its Period One contracts has little relevance to whether its future throughput will continue at the historical 100 percent load factor level of its Period One contracts.[222]

170. In reply, the Shipper Parties assert that Kern River has consistently exceeded 100 percent throughput for the years 2004-2009 and the year 2010. They assert that this is likely to continue given the lower rates that Kern River will have in Period Two.[223] BP addresses the load factor issues in greater detail, asserting that the participation in this Period Two hearing of shippers with 88 percent of Kern River's MDQ indicates the importance of Period Two capacity to the shipper parties in this proceeding.[224] BP states that Kern River represented to this Commission that the incremental capacity involved in its Apex Expansion (266,000 Dth/d) has been fully subscribed and there will be adequate access to gas supplies on its November 1, 2011 scheduled commencement date.[225] BP also cites numerous statements by Kern River in other proceedings that Kern River has adequate access to western gas supplies and that gas production is expected to increase by 3.1 Bcf/d to well over 12.5 Bcf/d in 2012.[226] It also notes that Kern River's President and other officers have been very positive about Kern River's future in their public presentations, as has Standard and Poors.[227] BP further asserts that Kern River's argument that it faces a higher degree of contract exposure contains statistical errors that make the analysis unrepresentative.[228] Finally, BP notes that Kern River has pursued a rate design that would maximize

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[221] Kern River Brief on Ex. at 26-27. However Kern River itself suggests elsewhere that there were positive, if modest, short term opportunities for growth in 2010 in the California and Nevada markets. *See* Ex. NVE-2 at 6.

[222] *Id.* 27-28.

[223] Morgan Stanley Brief op. Ex. at 10-11; BP Brief op. Ex. at 9.

[224] BP Brief op. Ex. at 5-6.

[225] *Id*. 6-7.

[226] *Id*. 8-9.

[227] *Id*. 6, 7-8, 14-15.

[228] *Id*. 26-27.

the level of its proposed Period Two rates, which is inconsistent with its argument that it faces extensive price competition.[229]

171. The Commission first reviews the historical context of this debate. In Period Two, Kern River will be marketing capacity to its Period One customers that are selling gas to established markets in southern California. As such, Kern River is not marketing incremental pipeline capacity to that market, but will negotiate first with existing customers who have an interest in protecting their positions in that market. Those negotiations will be based on Period Two rates that will be significantly less than the Period One rates applicable to the expiring Period One contracts <u>and</u> will be lower than any recourse rates that will apply to any Period Two capacity that existing shippers do not subscribe. Thus, while Kern River is correct that its historical throughput levels are based on its current contracts, the fact that its throughput has been in excess of its shippers' current Maximum Daily Quantities (MDQ) for the five year period 2004-2009 and 2010 as well indicates Kern River has been quite effective at competing at the margin for throughput that exceeds its firm contract subscriptions.

172. Thus at this juncture Kern River's throughput for the years 2005–2009 and 2010 continues to demonstrate its historically strong position in the southern California gas transportation market. The Commission now turns to Kern River's arguments that it faces greater contract risk due to (1) increased pipeline competition, (2) narrowing of basis differentials among producing areas, and (3) changes in production in the producing basins and supply sources for the consuming markets served by Kern River's system. As these arguments are based on information far outside the 2004 test period, they are relevant only if Kern River presents compelling testimony that the Commission should adopt what is in essence a new test period to determine its Period Two load factor.[230]

1. <u>The Risk from Expanded Pipeline Competition</u>

173. Kern River asserts that its contracting risk has increased due to competition from recent pipeline expansions serving the California market, particularly from

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[229] *Id*. 5.

[230] Under 18 C.F.R § 154.303(d) (2011), the Commission may allow <u>reasonable</u> deviation from the test period. Given the years 2009 and 2010 are five to six years beyond the 2004 test period, Kern River has a particularly heavy burden to show why using these later years is "reasonable."

the Ruby. Kern River asserts that 1.1 Bcf/d of Ruby's 1.5 Bcf/d capacity is subscribed and that it could expand by an additional .5 Bcf/d. Kern River thus concludes that the shippers that have signed contracts with Ruby are not available to contract for Kern River's Period Two and that this significantly increases its contracting risk.[231] There are two critical assumptions to this statement. The first is that the Ruby and other pipeline expansion capacity serves the same market as Kern River and does so at rates that are competitive for long term firm transportation capacity. The second is that Kern River is competing with Ruby for expansion capacity for which it must attract new shippers to fill its system. In this regard, the Commission first notes that Kern River and Ruby are not primary competitors in the same market. Kern River serves Los Angeles in southern California based on a construction cost that is at least 8 years old and will be 70 percent depreciated when the first Period One contracts expire. Ruby is designed to service the northern California and Oregon markets in light of the anticipated decline in Canadian gas now flowing to those markets.[232] The two pipelines serve different markets and given their different ages, their cost structures and rate designs would also be different.

174. Specifically, a shipper desiring to reach southern California using <u>long term</u> firm capacity on Ruby must pay a higher reservation rate plus whatever additional charges are required to reach the southern California market. Those charges would involve the transportation of gas from Malin on the Oregon border where Ruby terminates to Los Angeles, almost the entire length of California.[233] Thus a shipper having a Period One contract desiring <u>long term</u> firm capacity to serve an existing southern California market should be able to obtain a more favorable long term firm transportation rate by contracting for Kern River's Period Two capacity. While Kern River has omitted any explicit dollar per Dth comparison of the two pipelines from the record, the stated distinctions indicate that the Kern River's Period Two contract rates (and its recourse rates) should be significantly lower than Ruby's and the total usage charges lower due to the shorter mileage.

175. However, Kern River argues that competition should be measured not by the relative firm transportation reservation prices, but only between Ruby's usage

[231] Kern River Brief on Ex. 19-29, 25-26.

[232] *E.g.* BP Brief on Ex. 14-15, n. 32 and 33; Ex. KR-P2-18 at 12-13, 21-22; Ex. NVE-222 at 1-2.

[233] *Id.* 14, n. 26, 28.

rate and Kern River's full Period Two firm transportation rate.[234] This argument assumes that Kern River's shippers now moving gas to southern California will conclude that they will not need firm transportation contracts on either Ruby or Kern River to maintain their current presence in the southern California natural gas market. In doing so, they would be relying on Ruby remaining undersubscribed and that Ruby and its connecting pipelines to southern California market will have sufficient capacity over the short and long term such that there is no need to pay a firm reservation rate to reach that market. In other words, to pay only Ruby's usage rate a shipper to the southern California market must be one that will not need firm transportation contracts on Ruby and its connecting pipelines to assure long term access to that market. There is nothing in this record that suggests that Kern River's Period One shippers believe that transportation capacity on Ruby and its connecting pipelines would be adequate to meet their long term needs to reach the southern California market without long term firm transportation contracts. Under these circumstances, Kern River should have a material price advantage and appears sufficiently comfortable to have pursued a rate design that contains elements that would thereby increase its Period Two rates above those contemplated by the Commission. The pursuit of higher prices is not the sign of an endangered competitor. To the contrary, BP and Nevada have tendered their expressions of interest for 100,033 Dth/d of Period Two capacity beginning October 1, 2011,[235] or 100 percent of the 100,033 Dth/d of Period One contracts expiring on September 30, 2011.[236]

176. Moreover, while Kern River provides an exhibit showing total capacity serving the California market,[237] it does not address the relative prices or capacity of the other major pipelines serving southern California such as El Paso, Transwestern, or Mojave. Those pipelines are Kern River's direct competitors and

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[234] Kern River Brief op. Ex. at 1-22.

[235] *See* Letter of BP Energy Company to Kimberly D. Bose, Secretary of the Commission dated April 15, 2011 for filing in Docket No. RP04-274 and the attached letter from BP to Kern River dated April 1, 2011 (51,750 Dth/d); *see also* Letter of NV Energy Company to Kimberly D. Bose, Secretary of the Commission dated April 8, 2011 for filing in Docket No. RP04-274, Attachment A (48,283 Dth/d).

[236] *See* KP-P2-9 at 4, Table 1.

[237] Ex. No. KR-P2-14.

the absence of such information strongly suggests that such comparisons would establish that Kern River will have a strong competitive position based on its Period Two rates. In contrast to that the omission, the Commission notes that Kern River contracted its 2011 Axle project at the higher level of the 2003 Expansion rate, including a 13.5 percent equity rate of return.[238] Kern River was thus able to foreclose potential competition by meeting the needs of an existing customer.[239] Kern River sold the Axle project volumes at Period One rates that are higher than the Period Two rates it will offer to Period One customers now selling gas to established rather than incremental southern California markets. Thus, even if Kern River may have had to reduce its proposed expansion in 2010 to reflect limited demand new capacity at that time,[240] it has done well in protecting its existing markets. Moreover, the 2010 Expansion and Axle Expansion together increased Kern River's capacity by 23 percent and contradict Kern River's belittlement of its contracting possibilities.[241] The Commission notes that the Axle project's 266,000 Dth/d is only slightly less than the 273,000 Dth/d contained in the Period One contracts expiring through the end of 2013.[242] In fact, Kern River itself states that the contracts expiring before May 12, 2012 are 135,033 Dth/d,[243] which the Commission notes is less than either its 145,000 Dth/d 2010 Expansion or its 266,000 Dth/d Axle Expansion. As noted, of that 135,033 Dth/d Kern River already has expressions of interest for 100,033 Dth/d. In other documents Kern River itself has stated in 2010 that its revenue will be stable for the five year period through 2015 due to relatively low Period One contract expirations.[244]

177. In that vein, BP's reasonably suggests that the participation of Kern

[238] Ex. NVE-195 at 19-20.

[239] Ex. KR-P2-18.

[240] *Id.* 24.

[241] Ex. NVE-2 at 4.

[242] Ex. No. KR-P2-9 at 6, 8.

[243] Kern River Brief on Ex. at 28. In addition to the 100,033 Dth/d expiring on September 30, 2011, the balance through mid-2016 is 35,000 Dth/d on April 30, 2012 and 140,000 Dth/d on April 30, 2013. *See* Ex. KR-P2-9 at 4, Table 1.

[244] *See* Ex. NVE-2 at 4, 7.

River's current shippers in this proceeding reflects their recognition that the lower Period Two rates will provide a significant advantage to those shippers in maintaining their presence in the southern California market.[245] Ruby's entry to the northern California market may have increased the prospects of competition at the margin in Kern River's southern California market for gas sales that are not premised on the need for the long term transportation contracts to provide assured access to the southern California.[246] However this does not mean that Kern River has lost its relative advantage for providing long term firm transportation capacity to shippers that have participated in the southern California markets for many years and can sustain their position by contracting for the lower Period Two rates they themselves helped create. This is reflected in the expressions of interest that BP and Nevada Power have provided Kern River for capacity that expires on September 30, 2011.[247] This interest is in contrast to the absence from this record of any intention by Kern River's current shippers to pursue contracts with El Paso or Transwestern for delivery of gas to Los Angeles from the Permian Basin as a substitute for Kern River's expiring Period One contract capacity. The Commission concludes that in the absence of comparative price information and contract maturities on the other pipelines serving southern California Kern River's pipeline competition argument is inadequately documented and overstated.

2. The Risk from Narrowing Basis Differentials

178. Kern River's second argument is that increased takeaway capacity from the Rocky Mountain producing area will reduce the value of Kern River's capacity for transportation of gas to the southern California market.[248] It states that, before the

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[245] BP Brief op. Ex. at 5-6.

[246] As previously noted, Kern River has provided no evidence that the capacity south of Malin is actually or will become available.

[247] *See* Letter of BP Energy Company to Kimberly D. Bose, Secretary of the Commission dated April 15, 2011 for filing in Docket No. RP04-274-023 and the attached letter from BP to Kern River dated April 1, 2011 (51,750 Dth/d); *see also* Letter of NV Energy Company to Kimberly D. Bose, Secretary of the Commission dated April 8, 2011 for filing in Docket No. RP04-274-000, Attachment A (48,283 Dth/d). The total capacity is 100,333 Dth/d.

[248] Kern River Brief on Ex. at 25-26; Kern River Brief op. Ex. at 15; Ex KR-P2-18 at 15-20.

construction of the Rockies Express Pipeline (REX), the price of Rocky Mountain gas was depressed due to supply exceeding the pipeline capacity available to move the gas to the California market. However, REX permits Rocky Mountain gas to move to other markets. This means that shippers to the California markets that were previously paying relatively low prices for gas must now meet the higher prices that producers can obtain in other markets. This in turn narrows the difference between the price paid for the gas and the price it is sold in the California market. That difference in those two prices is called the basis differential. The higher the differential the higher the transportation rate the shipper can pay a pipeline to move the gas to a particular market. If a basis differential narrows to the point that it is less than the transportation rate, then either the pipeline must reduce its transportation rate or a shipper/producer must absorb all or part of the transportation rate in order to sell gas in the California market. Whether a shipper/producer will do so depends on how much access it has to pipeline options within the producing basin.

179. The increased prices that some producers can obtain for Rocky Mountain gas at the Opal pricing point, the beginning of the Kern River system, means that in general the price of gas delivered to California now reflects a greater value for the gas sales portion and a lower value for the transportation portion to the degree that producers will forgo transportation on Kern River and sell their gas elsewhere. Kern River argues that the increased ability to reach alternative markets has gradually narrowed the basis differentials (the relative price paid for the gas) among the differing markets to which Rocky Mountain gas can be transported. If the price differential becomes too narrow to cover the pipeline’s transportation rate and provide a netback to the producer that is competitive with possible sales to other markets, this pipeline is said to be “out of the money” rather than "in the money."[249]

180. At hearing, Kern River presented a summary of projected basis differential information between the gas price for Kern River and the sales price in southern California attached to Mr. Dushinske’s testimony.[250] The same data was also analyzed in Dr. Carpenter’s more detailed study of projected long term price differentials through the end of the Period Two contracting time frame.[251] The

[249] *E.g.* BP Brief op Ex. at 15.

[250] Ex. KR-P2-15.

[251] Ex, KR-P2-19 at 15-19.

study was based on a one-day snap shot dated May 28, 2010 and shows the projected sale and purchase prices for the first of each month for the period June 1, 2010 through December 1, 2010.[252] Both analyses concluded that there was a considerable risk that Kern River's capacity would not be "in the money" for much of the Period Two contracting time frame.[253] In other words, given the projected maximum level of Kern River's Period Two rates, a shipper might not contract with Kern River to move gas to the southern California market, but would elect to send its gas elsewhere. On exceptions Kern River argues that the study establishes the diminished value of its capacity and therefore a substantial contracting risk, or at least one that would require it to discount its rates. Kern River concludes that given the risk demonstrated by Mr. Dushinske and Dr. Carpenter's analyses, Kern River's load factor level should only be 95 percent.

181. In reply, BP states that Kern River's one day snap shot was prepared more than one year before the effective date of the first Period Two contract and as much as eight years before the effective date of some of the Period Two contracts.[254] BP asserts that in another proceeding Dr. Carpenter, Kern River's witness criticized the use of NYMEX-type quotes or basis swaps to extrapolate data multiple years into the future, stating that forward curbs based on these quotes are liquid only for one or two years.[255] This means that beyond that time frame there are insufficient trades to reliably establish what traders think the future prices (and differential) will be due to insufficient market activity. BP also states that the study does not adequately cover the entire Period Two contracting time frame.

182. BP also presents a chart asserting that the projected Period Two rates developed by each party other than Kern River shows that any of those Period Two rates would be "in the money." It therefore concludes that it is Kern River's own pursuit of a 13 percent equity return and other disputed costs that creates the situation of which it complains, or at least on some occasions.[256] Finally, BP asserts that Kern River's own internal presentations to investors that Kern River

[252] Ex. KR-P2-15.

[253] Ex. No. KR-P2-9 at 9-10; Ex. KR-P2-18 at 15-20.

[254] BP Brief op. Ex. at 9-10.

[255] *Id.* 9-11.

[256] *Id.* 13-14.

expects the capacity of the first two classes of shippers that will step down to Period Two rates to be fully subscribed, and that for the 2003 ten year shippers Kern River's MDQ and throughput will be higher than those it currently enjoys. BP asserts that there is no indication Dr. Carpenter saw those materials before preparing his testimony.[257] For these reasons, BP and the other shipper parties conclude that Kern River will be able contract its Period Two capacity and continue its historical practice of operating at least 100 percent of capacity.[258]

183. The Commission concludes the long tern statistical component of Dr. Carpenter's study is unreliable for the reasons stated by BP. In the short term it is contradicted by Kern River's own statements to its customers and investors. The value of the study is also undercut by the fact that it measures basis differentials against rate components that the Commission's prior orders stated would not be acceptable to inclusion in Kern River Period Two rates. Again there is a fundamental contradiction between Kern River's pursuit of the highest possible rate it believes it can achieve here and the self-serving nature of Kern River's assertion that it will be uncompetitive at that rate level. The Commission acknowledges that basis differentials narrowed beginning in 2009 but also concludes that the conclusions of Kern River's basis differential study are too speculative to support a finding that long term changes in basis differentials will materially affect Kern River's Period Two contracting risk.

3. <u>Risks from Changes to Gas Supplies</u>

184. On exceptions Kern River argues that two fundamental changes related to gas supplies have weakened its competitive position. The first is that the take away capacity of the pipelines serving its producing basins is now some 12.7 Bcf/d in 2011 while production is projected to be only 9.2 Bcf/d in the same year.[259] Kern River states that this represents a shortage of supply that may preclude it from having sufficient volume to contract its Period Two capacity. Kern River also states that the increased pipeline capacity to the California market makes it possible to bring other sources of supply to Kern River's California markets and that these may displace Kern River's supplies. Kern River further

[257] *Id.* 14-15.

[258] *E.g.* BP Brief on Ex. at 17-18; BP Brief op. Ex. At 7-9; Trial Staff Brief op. Ex. at 16-19; Morgan Stanley Brief op. Ex. at 11-12.

[259] Ex. KR-P2-9 at 18 and Ex. KR-P2-9 at 11-12.

asserts that increased production in California oil and gas producing fields and imported LNG provide additional sources of supply that may reduce the transportation of gas over its system.[260] It states that these increases in supply are coming on line at a time when the growth in demand of its California and Nevada markets has slowed.[261]

185. In reply, BP states that Kern River's supply arguments are contradicted by its materials produced by its own management and submitted in other proceedings. These include projections that Rocky Mountain supply would be well over 12.5 Bcf/d by 2012[262] and Kern River's representations to the California Public Utility Commission that there is strong potential growth in gas supplies in the Rocky Mountain region.[263] BP also states that Kern River argued in its opposition to the Ruby project that there could be as much as 3.2 Bcf/d increase in gas supplies by 2015 and to this Commission, that there was adequate supply to support its recent expansions.[264] BP states that Ruby's own justification for the construction of Ruby's system states that the Rocky Mountain Basin producing areas will experience rapid expansion and provide adequate gas supplies for its capacity.[265]

186. The Commission concludes that the evidence regarding future gas production is at best contradictory, and that in any event there are several limitations to Kern River's analysis. First, as with its capacity analysis, Kern River assumes that its Period Two contracts will most likely involve competition for new transportation customers and thus for supply that does not already have a presence in the southern California market. Kern River also assumes that its Period One customers are likely to abandon the use of its system to reach their current positions in the southern California market or can readily shift the sale of their current supplies to other markets.[266] There is no indication on this record

[260] Ex. No. KR-P2-9 at 11-12.

[261] *Id.* 10-11.

[262] BP Brief op. Ex. at 7-8.

[263] BP Brief on Ex. at 14-15; BP Brief op. Ex. at 8.

[264] *Id.*

[265] Citing Ex. NVE-222 at 2.

[266] *See, e.g.,* Trial Staff Brief on Ex. at 17-18.

that there is a material risk that its customers will do so, given the lower firm transportation rates that Kern River will be offering in Period Two. Moreover, Kern River assumes that production will not increase in response to any increase in gas prices resulting from the increased take-away capacity. In fact, its argument regarding increased takeaway capacity is inconsistent based on Kern River's own statements to this Commission in support of Kern River's 2010 Expansion.[267]

187. Kern River's argument that increased capacity to the California market will supplant Kern River supplies also has some questionable assumptions. These include: (1) that any new or increased capacity can efficiently serve Kern River's existing southern California markets, including the specific destinations Kern River now serves directly rather than through pipeline connections; and (2) that any such capacity is sufficiently price competitive with Kern River that the shippers currently using it would find themselves unable to match the delivered price offered by any such additional gas supplies. Kern River provides no details supporting a conclusion that it may lose its current relative advantage at specific delivery points or that its shippers may cease to be competitive for sales to specific generators given the lower rates it will be charging for its Period Two capacity. Similarly, Kern River provides no details on the relative competitiveness of any new California gas supplies that will be provided by the new interstate or within-state sources or their timing. For example, Kern River states that increased production by Occidental Petroleum may come on line over the next five to ten years, without providing any other information about those supplies.[268] Given such broad time frames those statements are speculative and are inadequate to establish that the projected new supplies will displace the existing gas supplies that are currently moving to southern California over the Kern River system.

4. **Summary and Conclusions**

188. In Opinion No. 486 and Opinion No. 486-A, the Commission applied its test period methodology and held that Kern River's actual 2004 test period billing determinants should be used to design its Period One rates.[269] The Commission finds that it is just and reasonable to use the same billing determinants to design

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[267] Ex. NVE-195 at 11-12.

[268] *See, e.g.* KR-P2-17.

[269] Opinion No. 486, 117 FERC ¶ 61,077 at P 76-86, *order on reh'g,* Opinion No. 486-A, 123 FERC ¶ 61,056 at P 74-89.

Kern River's Period Two rates. However, even if one applies the test period concept to the updated throughput figures for 2005 – 2009 and the year 2010, the conclusion would be the same. In all of six of those years Kern River's load factor was in excess of 100 percent.[270] Even using the calendar year 2010 as a proxy base period for a test period analysis, any changes to the existing 100 percent load factor would be outside the nine month adjustment period and after the first possible Period Two rates become effective on October 1, 2011.

189. Based on the analysis in the previous three sections, the Commission concludes that Kern River's arguments regarding current market conditions (2005-2010) have not justified a departure from the 2004 test period billing determinants based on changes that have occurred, or will occur, far outside that test period. Given the limitations to Kern River's arguments it has not justified departing from the holding stated in Opinion No. 486-D "that the starting point for calculating the Period Two rates in this proceeding must be the cost of service the Commission has already determined for Period One based upon the 2004 test year data used in this section 4 rate case."[271] As Morgan Stanley and Trial Staff state, if a 100 percent load factor proves to be unrealistic and ultimately results in rates that are unjust and unreasonable, Kern River's remedy is to file a new section 4 rate case using a test period that conforms to the Commission's test period regulations.[272] The Commission affirms the ID's holding that Kern River's Period Two rates should be designed on the same billing determinants as the Commission approved for Period One, and the Commission affirms the ID's rejection of Kern River's proposal to design its Period Two rates based on 95 percent of its design capacity.

D. Adjustments to Return on Equity in Period Two

190. 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.[273] However,

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[270] ID, 135 FERC ¶ 63,003 at P 1030, 1032, 1034-36.

[271] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 193.

[272] Morgan Stanley Brief op. Ex. at 11; Trial Staff Brief on Ex. 16 (citing ID 135 FERC ¶ 63,003 at P 1031).

[273] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 97.

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 the 100 percent equity capital structure Kern River would have in Period Two.[274]

191. In its Period Two compliance filing, Kern River contended 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. In Opinion No. 486-D, the Commission stated that, while the August 1992 Order in Kern River's original certificate proceeding clarified that Kern River would have a 100 percent equity capital structure in Period Two, the Commission had reserved the right to reexamine Kern River's return on equity in light of the change in capital structure. Opinion No. 486-D stated that consistent, with the August 1992 Order and Opinion No. 486-C, the parties were permitted 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 were permitted to present testimony supporting a return on equity below the median, Kern River was permitted to present testimony supporting an adjustment above the median.[275] The Commission unambiguously held that any testimony supporting any adjustment above or below the median must be based on 2004 test period information and that the parties could not change the proxy group or the equity range of 8.8 to 13 percent adopted by Opinion No. 486-B.[276]

<u>Initial Decision and Briefs on and opposing Exceptions</u>

192. The ID concluded that neither Kern River on the one hand, nor the Shipper Parties and Trial Staff on the other, had justified a departure from the median. The ID rejected Kern River's argument that its equity cost-of-capital should be adjusted to reflect an investor's requirement of a higher return in future years to compensate for the fact that Kern River would be establishing rates some eight to fourteen years after the 2004 test period. Reviewing Kern River's analysis of the difference in the 10 year Treasury bond rate between 2004 and 2018 as a justification for a 13 percent ROE, the ID concluded that this analysis was based

[274] *Id.* P 117.

[275] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 197.

[276] *Id.*

on speculation regarding future interest rates.[277] However, the ID accepted Kern River's statements that it would have higher business risk in the future that are offset to some extent by the 100 percent equity structure that will control in Period Two. The ID therefore rejected the Shipper Parties and Trial Staff's arguments that Kern River should have an ROE of 8.8 percent.[278] The ID therefore held that an 11.55 ROE should be used to design Kern River's Period Two rates.

193. On exceptions, Kern River agrees with the ID that any reduction in risk from the use of a 100 percent equity capital structure in Period Two will be offset by various risks related to the contracting of Kern River's Period II capacity. Those risks include: (1) the lack of contracts for Period Two; (2) the imbalance between available gas production and pipeline transportation capacity; (3) the narrowing of forward basis differentials; (4) the loss of future contracts to Ruby, the latter's equity premium of its initial capacity, and the possibility of its expansion; and (5) the limited demand for new capacity on Kern River's system. Kern River states that during Period One it provided needed capacity to end-users in California for Rocky Mountain gas supplies that had no other access to that market. It asserts that it is the success of its strategy that has laid the foundation for the lower rates that will occur in Period Two. Kern River argues that reducing its ROE below 11.55 percent would penalize it for the prudence it has shown in managing its system during Period One. Kern River concludes that it would be inconsistent with Commission policy to penalize Kern River by lowering its ROE to 8.8 percent in Period Two.[279]

194. Kern River also asserts that the ID erred by not recognizing that the same contracting risks that support the ID's conclusion not to lower the Period Two ROE also support Kern River's need for a higher ROE for its Period Two rates. Kern River asserts that those same risks are the source of uncertainly that would cause an investor in 2004 to require a risk premium given the long time period between 2004 and the time frame in which the Period Two contracts would become effective (2011 to 2018). Kern River asserts that this long term uncertainty means that investors would require a higher rate of return in 2004 to compensate them for an uncertainty that occurs so far in the future. This is in contrast to the lower and comprehensible near term risk reflected in the contracts

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[277] ID, 135 FERC ¶ 61,003 at P 1020, 1023.

[278] *Id.* P 1025-26.

[279] Kern River Brief op. Ex. at 20-21.

that Kern River had in effect in 2004. Given this difference in short and long term equity risks, Kern River concludes that its ROE should be placed at the upper end of the reasonable range of returns for 2004 or 13 percent using its risk premium methodology.[280]

195. Kern River asserts that its risk premium approach is a recognized method of determining the forward cost of capital and as such is not inconsistent with the Commission's traditional discounted cash flow methodology.[281] Turning to Kern River's testimony, which explains its argument in greater detail, Kern River's proposed risk premium methodology is based on the difference in forward interest rates for U.S. Treasury yield curve over an eight year or ten year period based on the difference between short and long term rates as of May 28, 2010.[282] The methodology thus compares the 2018 yield to the 2028 yield and concludes that the long term premium is 1.79 percent. The same calculation for the period 2020 to 2030 yielded a premium of 1.49 percent and for 2018 to 2026 a premium of 1.79 percent. Applying this methodology by a series of estimates to the 2001 Original System's 15 year contracts and the 2003 Expansion's 15 year contracts (those with the greatest expiring capacity), Kern River concluded that the risk premium attributed to the "future" rate for these contracts ranged from 1.4 to 2.3 percent for the 2001 Original System 15 years contracts and 1.5 percent to 1.8 percent for the 2003 Expansion 14 year contracts. Kern River asserts that this supports a risk premium for an eight to then year period of 150 to 200 basis points, which would equal or exceed 13 percent. It also concluded that its analysis was sound because equity returns track interest rates and both equity returns and interest rates are affected by inflationary trends.[283] Kern River therefore concludes that the use of a range of estimates is appropriate and as such is neither speculative nor inappropriate.[284] Finally, Kern River argues that the equity cost-of-capital in Period Two reflects the contracting risks that will occur in Period

[280] Kern River Brief on Ex. at 23, 24-25.

[281] Ex. No. KR-P2-30 at 6-7, 9-11.

[282] Ex. KR-P2-18 at 29-31, 33-34.

[283] *Id.* 35.

[284] Kern River Brief on Ex. at 24-25.

Two. Therefore the equity cost-of-capital is clearly a transitional issue from Period One to Period Two. Kern River concludes that therefore it may present more recent information regarding its prospect risk in Period Two.[285]

196. In contrast to Kern River, the Shipper Parties oppose the ID's refusal to lower Kern River's ROE to 8.88 percent (the lower end of the range) and support its decision not to increase Kern River's ROE to 13 percent. The central argument of several Shipper Parties and the Trial Staff is that the reduced financial risk Kern River will experience because of its Period Two 100 percent equity structure is not offset by increased business risk in Period Two.[286] In fact Trial Staff asserts that the first problem with the ID's conclusion in that regard is that the decision does not address the specifics of any risks.[287] Second, and more fundamentally, the risk information presented by Kern River all fall outside the 2004 test period.[288] Trial Staff further asserts that risk arises from the debt, not the equity component of the pipeline's capital structure, and therefore Kern River will have no financial risk in Period Two.[289] Trial Staff notes that in Period One Kern River had a debt to equity ratio of 62 percent. It further notes that despite this high debt to equity ratio, Kern River's Standard and Poors bond rating in 2004 was A-, higher than four of the five companies in the relevant proxy group and therefore its relative risk will be even lower once its debt is repaid.[290]

197. The Shipper Parties make several additional arguments they claim warrant the reduction of Kern River's ROE in Period Two. They assert Kern River will have amortized 70 percent of its rate base in Period One, its rates will be notably lower in Period Two, and it will recover the balance of its original rate base in Period Two.[291] As with the rate design volume issue, BP states that Kern River itself acknowledges that it has a significant advantage over its competitors because

[285] *Id.* 20.

[286] Trial Staff Brief on Ex. at 5-6, 8-9.

[287] *Id.* 5; Kern River Brief op. Ex. at 17, n34.

[288] *Id.* 5-6.

[289] Trial Staff Brief on Ex. at 10.

[290] *Id.* 12.

[291] Rolled-In Customer Group Brief on Ex. at 30-31.

it can avoid rate-stacking with downstream distribution companies in the California market.[292] BP notes that Kern River's own officers have stated that it has a bright future[293] and that an all equity capital structure with 11.55 percent after tax rate of return yields a pre-tax return of roughly 18.5 percent, which is far too high given Kern River's relatively low Period Two business risk.[294] BP states that the fact Kern River has no Period Two contracts is not relevant because at this point the Period Two contracting issue applies to only a few contracts that have yet to expire. As such, Kern River is no different than any other pipeline that has contracts expiring over several years. BP asserts that in fact Kern River's contracting risk is less than its proxy group given that even at its higher Period One rates Kern River operates in excess of its certificated capacity.[295] The Shipper Parties thus conclude that Kern River's arguments regarding the Ruby Pipeline and its expansion capacity are false given Kern River's own statements that it is the pipeline of choice to many California points.[296]

198. The Shipper Parties and Trial Staff advance the same arguments to support the ID's conclusion that Kern River's contracting risk for Period Two does not warrant an ROE of 13 percent in Period Two. They also assert that the ID properly rejected Kern River's risk premium methodology. Trial Staff states that there is no need to consider a risk premium at all because debt and equity are fundamentally different instruments. Both Trial Staff and the Shipper Parties state that a debt investor locks in the yield at the time of the purchase and the yield and cost can be precisely determined. An NGA section 4 rate filing does not change the cash flow or return that would flow to the bondholder as long as the pipeline retains its credit rating. Thus the bondholder has fewer opportunities to cover future risks than an equity holder through the use of rate filings.[297] This contrasts with an equity investor who is protected by the pipeline's right to file a section 4 rate case to increase its rates and the return on equity if the equity cost of capital

[292] BP Brief on Ex. at 14.

[293] *Id.* 15.

[294] *Id*. 17.

[295] *Id*. 17-18.

[296] Southern California Generation Coalition Brief on Ex. at 17-20; *See* Ex. NVE-2 at 4.

[297] Trial Staff Brief on Ex. at 15-16.

rises. Noting that the ID relied on testimony that Kern River would remain highly competitive. Trial Staff states this contradicts Kern River's argument for at risk premium for the cost of equity capital between 2016 and 2018.[298] Trial Staff further asserts that there is no evidence that the Period One shippers intend to jump ship to competing capacity and Kern River undercuts its own arguments by proposed relatively high rates for its Period Two contracts.[299]

199. Trial Staff and the Shipper Parties also assert the Kern River's risk premium methodology is fundamentally flawed. Trial Staff asserts that Kern River mixes the cost of debt in 2004 with the future cost of capital under its risk premium methodology, not the current cost of capital in 2004 although Kern River characterizes it as such.[300] Trial Staff and BP assert that this inconsistent with the Commission's determination that all cost-of-capital calculations should reflect the 2004 test year.[301] The Southern California Generator Coalition similarly states that Dr. Carpenter's bond data is from a time frame [2008] outside the 2004 test period.[302] Trial Staff likewise argues that given the Commission's unambiguous statement that cost-of-capital issues must be governed by the 2004 test year, Kern River cannot reasonably argue that the future cost of equity is a transitional issue that can be addressed through evidence from outside the 2004 test period. Finally, Trial Staff argues that the use of a risk premium methodology is speculative and is even more difficult to implement than the growth components of the Commission's traditional DCF methodology.[303]

Commission Determination

200. As has been previously stated, the Commission has consistently held that the starting point for calculating the Period Two rates in this proceeding must be "the cost of service the Commission has already determined for Period One based

[298] *Id.* 13-14.

[299] Trial Staff Brief op. Ex. at 17-18.

[300] *Id.* 11-12.

[301] *Id.* 14-15; BP Brief op. Ex. at 26.

[302] Southern California Generator Coalition Brief op. Ex. at 26.

[303] Trial Staff Brief on Ex. at 14-15.

upon the 2004 test year data used in this section 4 rate case."[304] As the Shipper Parties and Trial Staff argue, the Commission cannot have been more explicit that cost of capital issues were to be decided based on the 2004 cost-of-service. The Commission stated that "[I]t also follows that any testimony supporting any adjustment above or below the median should similarly be based on 2004 test period information."[305] Thus, changes to the 11.55 percent rate of return adopted by Opinion Nos. 486-B and 486-C must be based on the information that investors had available to them in 2004. However, Kern River's arguments concerning its contracting risk are based on perceptions of events that actually occurred in 2010 and 2011 and are therefore not properly before the Commission. Moreover, the risk premium approach Kern River advances here uses data for 2010 rather than 2004, which is both outside the test period and is taken from a period when short term interest rates were unusually low. Thus, the specifics underpinning the higher risk environment that Kern River claims now obtains would unlikely have been visible even to the most discerning investor. As the Shipper Parties and Trial Staff state, even at this point Standard and Poors has concluded that Kern River's prospects are more favorable than negative given current information.[306]

201. The Commission has a strong presumption that most regulated pipelines fall within a broad range of average risk absent highly unusual circumstances that indicate anomalously high or low risk compared to other pipelines. Thus, a party must make a very persuasive case that there are such highly unusual circumstances that would justify departing from the median value of the range of reasonable returns developed by the proxy group.[307] In this case, that value is the 11.55 percent adopted by Opinion No. 486-B and Opinion No. 486-C, because there was no persuasive evidence of unusual circumstances in 2004 that would support departing from the median value of 11.55 percent.[308] Given that standard, to depart from the median in determining the ROE for Kern River's Period Two rates requires a finding that an investor <u>in 2004</u> would conclude based on information

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[304] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 193 (emphasis added).

[305] *Id.* P 197.

[306] Trial Staff Brief op. Ex. at 18; BP Brief op. Ex. 7-8, also noting Kern River's projected revenue stability through 2015.

[307] Opinion No. 486-B, 126 ERC ¶ 61,034 at P 138, 140 (citing *Transcontinental Gas Pipe Line Corp.*, 90 FERC at 61,936).

[308] *Id.* P 146-48, 153; Opinion No. 129 FERC ¶ 61,240 at P 97, 115-16.

available at that time that there would be such unusual circumstances between 2011 and 2018 that the investor would require a ROE higher than the median. This would require compelling evidence that the investor would perceive Kern River would be a pipeline of greater or lower than average risk in that seven year time frame.

202. Applying that standard, the Commission concludes an informed investor would have knowledge <u>in 2004</u> of Kern River's consistently strong throughput level, its superior credit rating, and history of successful expansions. The investor would realize that Kern River's first Period One contracts would expire in 2011, and that the total contract expiration through early 2016 would involve relatively small amounts spread out over the years 2011-2013.[309] An informed investor would discern that Kern River probably faced some risk of increased pipeline competition due to the wide basis differentials that initially gave Kern River's capacity its value. However the investor would also conclude that, given Kern River's success in obtaining contract expansions, the competitive risk to its existing markets was not particularly threatening given Kern River's ability to forestall entry through its expansions.

203. Moreover, it is most unlikely that the investor would foresee construction of new capacity seven years after 2004 on the scale of REX and its possible impact on basis differentials, or that a pipeline on the scale of Ruby would be built to carry gas to the northern California-Oregon market. The previous section analyzed why Kern River has overstated such events based on current information; if anything, the investor would be inclined to view Kern River's prospects as more favorable than threatened. In fact, in the growth market that was in effect in 2004, Kern River's history of successful expansions as late as 2003 would suggest the firm had a position that would help it meet the potential competition for new entrants or additional gas suppliers. The investor would also review closely the issue of shipper credit risk based on certain events in the California market in 2003 and 2004, but would conclude that shipper credit quality problems would probably be overcome and that Kern River would maintain is consistently high load factor.[310] Therefore, the investor would conclude that Kern River faced modest contracting risk some seven to ten years in the future and would not price Kern

[309] The amounts are 100,033 on September 30, 2011, 35,000 on April 30, 2012, and 140,000 on April 30, 2013. Ex. No. KR-P2-9 at 4, Table 1. As previously noted, Kern River has expressions of interest from BP and NVE at this time for the 100,033 of Period One contracts expiring on September 30, 2011.

[310] Opinion No. 486-B, 126 FERC ¶ 61,034 at P 146.

River's equity at a return that would be above the median of the proxy group, that is the 13 percent advanced by Kern River. There is nothing in the 2004 record that suggests that (1) the risk in contracting capacity was so high that a premium return would be required for the period 2011-18, or (2) the gas supply environment presented reasonable concerns that Kern River's supplies would be displaced.[311]

204. The Commission also concludes that in 2004 investors would be unlikely to view Kern River's equity as so low risk in the period 2011 through 2016 that Kern River's return should be placed at the lowest possible point in the range of reasonable returns, or 8.8 percent. It is true that investors would recognize the Kern River's capital structure would <u>gradually</u> evolve to a 100 percent equity structure beginning in 2011 and that this would gradually reduce its financial risk as its debt was retired. The investor would recognize that this reduced financial risk would mitigate Kern River's contracting risk because the equity component of its capital structure would increase in parallel to the expiration of the Period One contracts. But this does not mean that Kern River's business risk would necessarily be so low that investors could be assured that changes in Kern River's capital structure would offset all of the potential competition from new pipeline capacity or gas supply. This record does not provide compelling evidence that there is a one to one correlation in the change of Kern River's financial risk that would offset the contracting risk that Kern River would face over the time frame that its Period One contracts would expire. In 2004, Kern River's capacity had strong underlying value precisely because the absence of other take away capacity reduced the ability of producers to sell their gas in other markets with a narrower basis differential. The fact that those relatively high basis differentials existed in 2004 creates an incentive for entry by competing firms and the scope of the entry would be hard to quantify in 2004, as opposed to the retrospective approach the parties advance here based on the more detailed information that has become available some seven years after the close of the 2004 test period.

205. Moreover, because the Period Two 100 percent equity structure would come on line gradually from 2011 through 2018, it would be viewed in 2004 as part of a composite equity that was subject to generic business risks applicable to all of Kern River's equity structure regardless of its vintage. Examining these generic risks, an investor would likely focus on the Period Two contracting risk occurring before September 2016, noting that it is a relatively small part of Kern River's total capacity. This is because the period through the end of 2015 is over 11 years beyond the end of the 2004 test period, or a time frame more than two

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[311] *Id.*

times the five year period used by financial analysts in forecasting the growth prospects of individual firms.[312] Any evaluation of future risks declines after five years, and in that regard Kern River itself has stated in 2010 that it anticipates revenue stability through the end of 2015, a forecast of five years.[313] Given the time frame involved and the low volume of contract expirations through 2015, the investor would focus on such issues as Kern River's ongoing credit risks and other routine business risks. In doing so, the investor would likely conclude that the Kern River's overall business risk would be little different during the initial years of Period Two rates than that attributable to the Period One rates that would remain in effect in the same ten to eleven year time frame, including the Period One debt that was still outstanding though 2015. The fact is that the financial and business risks attributed to the some 88 percent of Period I contracts remain in effect through the end of 2015 would trend the required ROE toward the median rather than the lower end of the range in absence of highly persuasive information (evidence) to the contrary. This does not exist in the present record. The ID correctly declined to reduce Kern River's Period Two ROE below the median.

206. Given that conclusion, the Commission further concludes that Kern River is correct that reducing its return to the lower end of the median would penalize Kern River for the efficiency with which it has managed and expanded its system. Throughout Period One, Kern River's deferred equity return has been calculated at the median of the reasonable range of equity returns.[314] Thus, while the pretax return on equity appears high because no debt is included in determining the Period Two rates, the original bargain between Kern River and its shippers explicitly contemplated the use of a 100 percent equity structure as the various Period One contracts expired. Trial Staff and the Shipper Parties have not presented compelling evidence based on the 2004 test period that Kern River's return on equity should be reduced below the median over the time frame the Period Two contracts will be executed. To the extent more recent information suggests otherwise, this must be presented in the context of another rate proceeding. The ID's holding that the Period Two rates should reflect the same 11.55 percent ROE as the Period One rates is affirmed.

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[312] *See* Opinion No. 486-B, 126 FERC ¶ 61,034 at P 119-121.

[313] Ex. No. NVE-2 at 4.

[314] Opinion No. 486-B, 126 FERC ¶ 61,034 at P 146-148, 153, *order on reh'g,* Opinion No. 486-C, 129 FERC ¶ 61,240 at P 100, 114-116.

E. Roll-in of the 2010 Expansion of Kern River's System

207. In 2009, the Commission granted Kern River a certificate to expand its system, with service to commence in 2010 (2010 Expansion).[315] Kern River requested a predetermination that it can roll the costs associated with the 2010 Expansion into the incremental rates applicable to Kern River's 2003 Expansion service in its next rate case. Kern River asserted that the 2010 Expansion revenues will exceed the cost of service of the 2010 Expansion and therefore rolling in the costs will not result in subsidization of the 2010 Expansion by existing 2003 Expansion shippers. The Commission granted Kern River's request for a predetermination to rolling in the costs for the 2010 Expansion into the incremental 2003 Expansion rates, as well as rolling fuel attributed to the 2010 Expansion into the 2003 Expansion fuel reimbursement rates.

208. In this case, some Kern River shippers contended that the costs and volumes used to design the Period Two rates should reflect the roll-in of the 2010 Expansion of Kern River's system. The ALJ rejected that proposal. The ID finds that neither Opinion 486-D, nor any other previous order of the Commission, set this issue for determination in this proceeding. In addition, the ID finds that the 2010 expansion does not represent a unique transitional issue, which should be included in this proceeding.[316]

Briefs on and opposing Exceptions

209. Morgan Stanley argues that the ID erred by not requiring Kern River to reflect the roll-in of the 2010 Expansion in the volumes used to calculate Period Two rates. Morgan Stanley notes that Kern River has not proposed such a roll-in of facilities but states that the Certificate Order authorizing Kern River's 2010 Expansion, granted Kern River's request for a pre-determination to roll-in the 2010 Expansion to its existing 2003 Expansion shippers' class for both the 10-year or 15-year service terms.[317]

210. Morgan Stanley asserts that at hearing Kern River argued that neither Opinion No. 486-D nor any other Commission order set the effect of the 2010 Expansion roll-in for determination in this proceeding. Morgan Stanley argues

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[315] 127 FERC ¶ 61,223, at P 27 (footnote omitted); *Id*. P 47.

[316] ID, 135 FERC ¶ 63,003 at P 333 (citing KR-IB at 67-68).

[317] Morgan Stanley at 22 (citing *Kern River Gas Transmission Co.*, 127 FERC ¶ 61,223 at P 28).

that such an argument overlooks the fact that the Commission explicitly allowed the parties to project the volumes used to design rates and allocate costs for Period Two, which Morgan Stanley asserts includes the effect of the 2010 Expansion roll-in in this proceeding. Morgan Stanley argues that Opinion No. 486-D explicitly stated that parties would be permitted to address projections for "the volumes used to design the Period Two rates and allocate costs" in this proceeding. [318] Morgan Stanley, therefore, asserts that because the impact of the roll-in of the 2010 Expansion directly affects the "volumes used to design the Period Two rates and allocate costs," it should be considered in this case. Therefore, it argues that under the language of Opinion No. 486-D, the impact of the roll-in of the 2010 Expansion on the volumes used to design Period Two rates and allocate costs is "unique to the transition from Period One to Period Two rates that justif[ies] an adjustment to the cost of service underlying the Period One rates."[319]

211. SoCalGas and SDG&E acknowledge that rolling the 2010 Expansion into the 2003 Expansion rates for Period One is not at issue here. However, SoCalGas and SDG&E argue that the impact of the roll-in of the 2010 Expansion rates for Period Two is a reduction of approximately $18 million per year in the costs allocated to the 2003 Expansion.[320] They assert that this roll-in should be recognized as an exception to limitation that Period Two rates should be developed based on the 2004 test year data, because the 2010 Expansion is unique to the time period between the 2004 test period and the beginning of Period Two, if not to the transition between Periods One and Two. They argue that Kern River has no obligation to file another rate case, nor does it have any incentive to do so while it is over-recovering approximately $18 million annually. Nevada Power also points out that the 2010 Expansion is in service and that the volumes are known and under long-term contracts. Nevada Power argues that the volumes and costs associated with that expansion are known and measurable and should be

[318] Morgan Stanley Brief on Ex. at 22 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 198 ("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.")).

[319] Morgan Stanley Brief on Ex. at 22 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 194).

[320] SoCalGas and SDG&E Brief on Ex. at 11-12.

used to design Period Two rates so that Kern River will not overcollect its cost of service.[321]

212. Kern River maintains that the ID correctly finds that the roll-in of the 2010 Expansion is not an issue in this proceeding and that the finding is fully supported by the Commission's orders in this case. Kern River argues that the roll-in of the 2010 Expansion is not unique to the transition from Period One to Period Two rates because Period Two will not even start until at earliest October 2011, which Kern River points out is more than a year after the commencement of the 2010 Expansion service.

213. Kern River also notes that parties on exception argue that the Commission stated in Opinion No. 486-D that because there are no contracts for Period Two service, Period Two rates must be designed based upon some projection of billing determinants for Period Two. Kern River asserts that the parties' contention that such a statement requires that the roll-in of the 2010 Expansion should be part of such a projection is in error. Kern River argues that in Opinion No 486-D the Commission specifically identified approaches for projecting Period Two volumes that could be considered at the hearing and did suggest that the 2010 Expansion should be part of any such projection.[322] Kern River also points out that in granting a presumption of rolled in treatment for the subject volumes the Commission stated that no final determination of the treatment of 2010 Expansion costs and volumes will be made until Kern River's next NGA section 4 rate case, not the instant rate case.[323] Therefore, Kern River argues that there is no basis for a finding that the Commission's comments in Opinion No. 486-D regarding projecting billing determinants for Period Two supersedes the Commission's prior order on the appropriate timing for a final determination on the roll-in of the 2010 Expansion. Kern River also states that, although several parties argue that if the 2010 Expansion volumes are not rolled-in here Kern River will over-recover its cost of service during Period Two, this argument also fails because the Commission has recognized that the proper venue for a final determination on the

[321] Nevada Power Brief on Ex. at 33-34.

[322] Kern River Brief op. Ex. at 75 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 198).

[323] *Id*. (citing *Kern River Gas Transmission Co*., 127 FERC ¶ 61,223 at P16, 18).

roll-in of the 2010 Expansion is Kern River's next rate case where all costs may be considered.

Commission Determination

214. The Commission affirms the ID on this issue. As the Commission emphasized in Opinion No. 486-D:

> 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. [324]

The Commission held that the only exception to this general approach to developing the 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."[325]

215. The 2010 Expansion did not go into service until over five years after the end of the 2004 test year. Commencement of service on that expansion in 2010 is unrelated to the transition from Period One to Period Two. Rolling the costs of that expansion into the 2003 Expansion rates would affect the rates of all 2003 Expansion Shippers, regardless of whether they are in Period One or Period Two. However, the Commission established this hearing solely for the purpose of determining Kern River's Period Two rates. Therefore, requiring a roll-in of those costs in this proceeding would be contrary to the Commission's holding in Opinion No. 486-D that the Period Two rates must be designed based on the same

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[324] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 193.

[325] *Id*. P 193.

cost of service as the Period One rates, absent circumstances unique to the transition from Period One to Period Two rates that justify an adjustment to the Period One cost of service. Moreover, such a roll-in should occur in a general rate proceeding under NGA section 4 or 5 where Kern River's entire cost of service is before the Commission, so that consistent data from the same time period for both the 2003 and 2010 Expansions can be used to carry out the roll-in.

216. There was nothing in the Commission's statement in Opinion No. 486-D that the parties could address at the hearing "the issue of whether the volumes used to design the Period Two rates and allocate costs should be based on upon 95 percent or Kern River's design capacity, a projection that its Period One contracts will be renewed, or some other basis" to suggest that parties could raise the issue of rolling in the 2010 Expansion. The Commission did not even mention the 2010 Expansion as one part of the part of the potential methods of projecting Period Two billing determinants.[326] While the Commission found in the 2009 order issuing a certificate for the 2010 Expansion that a predetermination in favor of a roll-in of such costs appropriate, it expressly contemplated that such a roll-in would occur in Kern River's next rate case, not the instant ongoing proceeding.[327]

217. Lastly, in Opinion No. 486-D, the Commission specifically addressed the issue of changes to the cost of service in the instant proceeding such as a roll-in of cost sought by parties on exception to the findings of the ID:

> 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.*[328]

218. Accordingly, the Commission affirms the ALJ's findings concerning the roll-in of the 2010 Expansion costs.

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[326] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 198.

[327] *Kern River Gas Trans.*, 127 FERC ¶ 61,233 at P 16.

[328] Opinion No. 486-D, 133 FERC ¶ 61,162 at n.229 (emphasis added).

VII. Instructions for Implementation

219. The Commission directs Kern River to file revised tariff records including both the Period Two rates and the eligibility requirements for those rates, consistent with the holdings of this order, on or before August 5, 2011. The tariff records setting forth the Period Two rates will be effective on October 1, 2011, and the tariff records setting forth the eligibility requirements will be effective on September 1, 2011. With regard to the eligibility requirements, as discussed herein, Kern River must revise its proposed GT&C section 30, as set forth in its Exhibit No. KR-P2-2, to (1) incorporate its proposal to permit Period Two shippers an option to obtain either 10-year or 15-year contracts, (2) eliminate any requirement that Period Two shippers must only obtain service under Rate Schedule KRF-1, and (3) set forth its obligation to file *pro forma* tariff sheets containing its proposed Period Three rates, on or before two years before the end of Period Two for the first set of expiring Period Two contracts.

The Commission orders:

(A) The ID is affirmed in part and reversed in part for the reasons stated in the body of this order.

(B) Kern River shall file revised tariff records including both the Period Two rates and the eligibility requirements for those rates, consistent with the holdings in this order, on or before August 5, 2011. The tariff records setting forth the Period Two rates will be effective on October 1, 2011 and the tariff records setting for the eligibility requirements will be effective on September 1, 2011.

(C) Comments on Kern River's compliance filing are due on August 17, 2011.

(D) Firm shippers on the Original System with Period One contracts expiring on September 30, 2011 must make a binding election whether to execute 10 or 15-year contracts for service under Period Two rates on or before September 1, 2011.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.