142 FERC ¶ 61,132
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Philip D. Moeller, John R. Norris,
Cheryl A. LaFleur, and Tony T. Clark.

Kern River Gas Transmission Company — Docket Nos. RP04-274-000
RP04-274-023
RP04-274-026
RP04-274-027
RP04-274-029
RP10-1406-002
RP11-2356-001
RP11-2356-002
RP11-1499-001
RP13-199-000

OPINION NO. 486-F

ORDER ON REHEARING

(Issued February 22, 2013)

Paragraph Numbers

1. On July 21, 2011, the Commission issued Opinion No. 486-E,[1] deciding various issues concerning (1) the cost of service and design of the Period Two step-down rates Kern River Gas Transmission Co. (Kern River) firm shippers may obtain when their current contracts expire and (2) the eligibility conditions those shippers must satisfy in order to obtain the Period Two step-down rates. On August 29 and September 30, 2011, the Commission issued orders accepting Kern River's August 5, 2011 filing to comply with Opinion No. 486-E. The August 29, 2011 Order accepted Kern River's proposed tariff records setting forth the eligibility conditions for the step-down rates, to be effective September 1, 2011, subject to Kern River submitting a compliance filing modifying various proposed eligibility conditions.[2] The September 30, 2011 Order accepted Kern River's tariff record setting forth the step-down rates for each firm shipper class, to be effective October 1, 2011.[3]

2. In this order, the Commission generally denies rehearing of Opinion No. 486-E. The Commission also addresses a request for rehearing of the August 29, 2011 Order and accepts Kern River's September 6, 2011, filing to comply with the Commission's August 29, 2011 Order subject to conditions. The Commission also acts on all other pending matters in this and related dockets, as described below.

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[1] *Kern River Gas Transmission Co., Opinion No. 486-E*, 136 FERC ¶ 61,045 (2011) affirming in part and reversing in part the initial decision of the Administrative Law Judge in, *Kern River Gas Transmission Co.*, 135 FERC ¶ 63,003 (2011) (ID).

[2] *Kern River Gas Transmission Co.*, 136 FERC ¶ 61,141 (2011) (August 29, 2011 Order).

[3] *Kern River Gas Transmission Co.*, 136 FERC ¶ 61,241 (2011) (September 30, 2011 Order).

I. **Background**

3. In January 1990, the Commission issued a certificate for Kern River to construct its Original System under the optional expedited certificate regulations adopted in Opinion No. 486.[4] In that order, the Commission approved initial rates based on, among other things, a levelized cost of service and a 25-year depreciation life. The Commission also authorized Kern River to charge separate levelized rates for three different periods: (1) the 15-year term of the firm shippers' initial contracts (Period One); (2) the 10-year period from the expiration of those contracts to the end of Kern River's assumed 25-year depreciable life (Period Two); and (3) the period thereafter (Period Three). The levelized rates for Period One (Period One Rates) were designed to recover approximately 70 percent of Kern River's original investment, an amount about equal to the portion of its invested capital funded through debt.[5] The Period Two rates would recover the remaining 30 percent of Kern River's invested capital. In addition, because 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 Period Two rates would be designed to return that excess recovery. The Period Three rates would recover only operating expenses, taxes, and a reasonable management fee.

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

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

[5] Original Certificate Order, 50 FERC at 61,144.

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

recover 70 percent of the costs of the plant being depreciated by the end of the new repayment periods.[7]

5. In May 2002, Kern River completed an expansion project by adding additional compression to its system (2002 Expansion).[8] These costs 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, there were six groups of levelized rate contracts, and the shippers under all those contracts were still paying Period One rates when the Commission issued Opinion No. 486-E.[10]

6. On April 30, 2004, Kern River filed a general rate case under section 4 of the Natural Gas Act (NGA). Kern River proposed 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 levelized rate contracts expire on six different dates, Kern River proposed different levelized Period One rates for each of the six groups of contracts. While the rates approved in the Original Certificate proceeding included separate, levelized rates for three

[7] *Id.* at 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 (2003 Expansion Certificate Order), *order on reh'g*, 101 FERC ¶ 61,042 (2002).

[10] The expiration dates of the various contracts are as follows:

> Original system – 10-year contracts (expire September 30, 2011); Original system – 15-year contracts (expire September 30, 2016); 2002 Expansion – 10-year contracts (expire April 30, 2012); 2002 Expansion – 15-year contracts (expire April 30, 2017); 2003 Expansion – 10-year contracts (expire April 30, 2013); 2003 Expansion – 15-year contracts (expire April 30, 2018). *See* Ex. KR-45 at 4, line 7-8.

[11] *See* Opinion No. 486, 117 FERC ¶ 61,077 at PP 4-17 (providing a detailed history of recent regulatory proceedings regarding Kern River's system).

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.

7. Since the original hearing in this rate case, the Commission has issued six opinions 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 because the Period One rates were part of the original risk sharing agreement underlying Kern River's optional expedited certificate.[13] However, in order to assure that the shippers would 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 resolved all issues concerning Kern River's Period One rates. The Commission rejected Kern River's section 4 rate increase proposal, and pursuant to NGA section 5, the Commission required Kern River to prospectively reduce its Period One rates below their preexisting level. 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] Kern River has complied with the Commission's requirements concerning Period One, including refunding its proposed rate increase.

[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, *order on initial decision*, Opinion No. 486-E, 136 FERC ¶ 61,045 (2011).

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

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

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

9. While the Commission had at this point determined general parameters concerning the design of the Period Two rates, the Commission had not yet established the specific rates to be charged in Period Two. In Opinion No. 486-C, the Commission found that levelized rates for Period Two were part of the original risk sharing agreement and, therefore, determined that levelized rates are required for Period Two.[16] 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]

10. Of particular import to the instant order, the Commission in Opinion No. 486-C found that these issues included the issue of whether, and how, the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two rate levelization period. The Commission stated that there appeared to be a number of options for resolving that issue, including, but not limited to: (1) requiring shippers to enter into contracts for the entire length of Period Two, if they desire levelized rates for Period Two, (2) offering the shippers one or more options permitting them to enter into contracts of some specified minimum duration but shorter than Kern River's remaining depreciable life, while nevertheless levelizing Kern River's Period Two rates over the entire remaining depreciable life, (3) offering optional contract lengths that are shorter than Kern River's remaining depreciable life as in the previous option, but 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 such issues and that the participants 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]

12. In November 2010, before the hearing directed by Opinion No. 486-C commenced, the Commission issued Opinion No. 486-D.[20] Opinion No. 486-D

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

[17] *Id.* P 247.

[18] *Id.*

[19] *Id*. PP 261-263.

[20] Opinion No. 486-D, 133 FERC ¶ 61,162,

denied Kern River's request for rehearing of Opinion No. 486-C's holding that its Period Two rates must be levelized,[21] and 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.[22] 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.[23]

13. Opinion No. 486-D also clarified the issues set for hearing in order to assist the parties and the Administrative Law Judge (ALJ).[24] Among other things, 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.[25] 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.[26]

14. Opinion No. 486-D also 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.[27] However, Opinion No.

[21] *Id*. PP 160-162, 176-177.

[22] *Id*. PP 165, 171-173.

[23] *Id*. P 200.

[24] *Id*. P 192.

[25] *Id*. P 193.

[26] *Id*. P 194.

[27] *Id*. P 197.

486-D clarified that the parties may not re-litigate other return on equity issues, including 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. Opinion No. 486-D also stated that any testimony supporting any adjustment above or below the median should be based on 2004 test period information.[28] Finally, Opinion No. 486-D permitted the parties 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.[29]

15. On December 6, 2010, the Commission issued an order in this proceeding and two related proceedings, clarifying the treatment of Kern River's compressor costs under its levelized rate methodology.[30] Requests for clarification and or rehearing of that order are addressed below.

16. On April 14, 2011, the ALJ issued his Initial Decision.[31] On July 21, 2011, the Commission issued Opinion No. 486-E, affirming 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.[32]

17. Opinion No. 486-E first considered issues related to 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. The Commission affirmed the ALJ's findings that (1) Kern River may require Period One shippers that choose to take service in Period Two to enter into Period Two contracts with terms of either 10 or 15 years at the shipper's election;[33] and (2) the entire remaining balance of Kern River's original capital investments may be levelized during the term of those contracts.[34]

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[28] *Id*. P 197.

[29] *Id.* P 198.

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

[31] ID, 135 FERC ¶ 63,003.

[32] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 1.

[33] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 60, (citing, ID, 135 FERC ¶ 63,003 at PP 1037-1051).

[34] *Id*.

However, the Commission also required that, at the end of the Period Two contracts, Kern River offer the Period Two shippers stepped-down Period Three rates, reflecting removal from Kern River's rate base of all its original invested capital.[35] With regard to other eligibility conditions for Period Two contracts, Opinion No. 486-E held that Kern River may require Period One shippers to give one year's notice of their intent to contract for Period Two service,[36] and that Kern River may require each Period One shipper to make a one-time election whether to execute a contract for Period Two service for an amount up to its current contractual entitlement for Period One service.

18. Second, Opinion No. 486-E discussed matters related to Period Two cost of service and rate design issues. The Commission affirmed the ALJ's findings 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; (2) the Period Two rates must be designed using Kern River's actual 2004 test period billing determinants; (3) the Period Two rates must reflect a 100 percent equity capital structure; and (4) the Period Two rates must include the same 11.55 percent return on equity as the Period One rates with no adjustment above or below the median of the range of reasonable returns.

19. On August 5, 2011, Kern River filed tariff records to comply with the determinations of Opinion No. 486-E, concerning both the Period Two rates and the eligibility requirements for those rates. Shippers filed protests and comments on that filing. Various parties, including Kern River, field requests for rehearing of Opinion No. 486-E.

20. On August 29, 2011, the Commission issued an order, accepting Kern River's proposed tariff records containing Period Two shipper eligibility requirements, to be effective September 1, 2011, subject to conditions.[37] The Commission found that certain eligibility conditions proposed by Kern River did not comply with the holdings of Opinion No. 486-E, and required Kern River to file revised tariff records concerning the Period Two eligibility requirements. On September 6, 2011, Kern River filed tariff records in compliance with the August 29, 2011 Order.

21. On September 30, 2011 the Commission issued an order holding that the proposed Period Two rates in Kern River's August 5, 2011 filing were consistent

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[35] *Id*.

[36] *Id*. P 82.

[37] August 29, 2011 Order, 136 FERC ¶ 61,141.

with the holdings of Opinion No. 486-E. Accordingly, the Commission accepted the tariff records containing those rates effective October 2011.

22. On February 1, 2012, the Commission issued an order approving an uncontested Settlement that resolved issues related to its Self Contained contracts and the implementation of Kern River's Rate Schedule KRF-1.[38] In brief, the settlement provides that the Self Contained contracts under which several of the Kern River shippers currently take service will be closed to new shippers and then eliminated. The settlement provides that all of Kern River's firm mainline shippers will be served under Rate Schedule KRF-1. The Settlement provides that all of the shippers will execute restatements of their currently effective contracts and may retain certain nonconforming provisions of their self contained contracts as they transition to Rate Schedule KRF-1 service as described in the Settlement. If a Settling Shipper elects Period Two service, the new Period Two contracts executed by such shipper will contain the subject nonconforming provisions. The settlement also provides that all protests in Docket No. RP11-2328 will be deemed withdrawn and that certain claims in other related dockets would also be withdrawn as discussed in greater detail below.

23. On October 31, 2012, Kern River filed a revised tariff record in Docket No. RP13-199-000 to adjust the 10-year and 15-year Period Two rates applicable to eligible 2003 Expansion Project shippers whose transportation service agreements (TSA) expire on April 30, 2013.

24. In this order, the Commission addresses the requests for rehearing of Opinion No. 486-E, the Clarification Order, and the August 29, 2011 Order. The Commission also accepts Kern River's filing to comply with the August 29, 2011 Order and Kern River's October 13, 2012 filing to adjust its rates for 2003 Expansion Project Shippers.

II. Rehearing of Opinion No. 486-E

25. For the reasons discussed below, the Commission denies rehearing of Opinion No. 486-E on all issues, with one exception. First, the Commission will address issues related to the duration of shipper contracts and their coordination with the length of the Period Two rate levelization period and certain eligibility requirements for Period Two contracts. Second, the Commission will address issues related to cost of service and rate design issues. As discussed below, the Commission will deny the requests for rehearing except as noted.

[38] *Kern River Gas Transmission Co.*,138 FERC ¶ 61,078 (2012).

A. NGA Section 5 Burdens

26. In Opinion No. 486-E, the Commission reaffirmed that it was proceeding under section 5 of the NGA in requiring Kern River to include Period Two rates in its tariff.[39] 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: we must demonstrate: (1) that the existing rate or practice is unjust and unreasonable; and (2) that the alternative rate or practice imposed by the Commission is just and reasonable.[40] Opinion No. 486-E stated that in the earlier proceedings in this case, the Commission had 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 unreasonable. Therefore, the purpose of the current proceeding is to establish just and reasonable Period Two rates, consistent with the second prong of the Commission's burden.

27. Opinion No. 486-E noted that Kern River and other participants had submitted various competing proposals concerning what just and reasonable Period Two rates the Commission should adopt. The Commission stated that, if it was satisfied that Kern River's proposed remedy was just and reasonable, it would adopt that remedy in preference to other just and reasonable remedies that may have been proposed by other parties.[41] Opinion No. 486-E cited orders in two cases involving ANR Pipeline Company (ANR) in support of this approach.[42] For example, in *ANR I*, the Commission stated that, in adopting a remedy 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

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[39] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 27 (citing, Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 109-110).

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

[41] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 39.

[42] In the first case, the Commission modified ANR's imbalance cash-out mechanism pursuant to NGA section 5, *ANR Pipeline Co.*, 109 FERC ¶ 61,138, at P 28 (2004), *order on reh'g,* 111 FERC ¶ 61,113, at P 19 (2005) (*ANR I*). In the second case, the Commission modified ANR's fuel cost tracking mechanism pursuant to NGA section 5, *ANR Pipeline Co.*, 110 FERC ¶ 61,069, at P 49, *order on reh'g,* 111 FERC ¶ 61,290 (2005) (*ANR II*).

> 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.[43]

Request for Rehearing

28. BP Energy Co. (BP) argues that Opinion No. 486-E erred by establishing a preference, in the remedial phase of this NGA section 5 proceeding, for the pipeline's proposed remedy, even if proposals by other proceeding participants are also just and reasonable. BP argues that this preference is not supported by case law and that it is unduly discriminatory and, therefore, it is not consistent with section 5 of the NGA.

29. BP argues that proposals by all active participants in the context of section 5 should be evaluated on a level playing field because if the pipeline is given a preference in section 5 remedial proceedings, the pipeline will have little incentive to make any reasonable adjustment as part of its section 4 presentation.

30. BP contends that a preference towards the pipeline's remedies would impose an additional burden upon the participants because participants would be required to demonstrate not only that their proposals are just and reasonable, but that the remedy proposed by the pipeline is unjust and unreasonable. BP argues that such a preference also decreases the likelihood that the Commission will adopt the best possible remedy and that it relieves the Commission of nearly all responsibility in a section 5 proceeding by eliminating the need to assess or otherwise determine that any alternative proposals are just and reasonable. BP asserts that this contradicts the statutory language, which provides that "*the Commission shall determine* the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force…."[44]

[43] *ANR I*, 109 FERC ¶ 61,138 at P 28 (citing, *Consolidated Edison Co. v. FERC*, 165 F.3d 992, 998, 1002-04 (D.C. Cir. 1999)).

[44] *Citing*, 15 U.S.C. § 717d(a) (emphasis added).

31. BP argues that, under NGA section 4, the pipeline bears the burden of proof, the Commission examines the pipeline's proposal and other participants respond to the pipeline's proposal. However, under NGA section 5, the burden of proof rests upon entities other than the pipeline, and these non-pipeline entities bear the burden of production / burden of going forward and the pipeline is then granted the opportunity to respond. BP asserts that the Opinion No. 486-E ruling ignores this difference between NGA section 4 and section 5 proceedings.

32. BP argues that after the participants show that the current rate is unjust and unreasonable, if the pipeline is to receive a preference in a section 5 proceeding, the pipeline should bear the burden of production and file evidence in support of its remedial proposal before the proposals of the other participants in the proceeding. BP argues that:

> [T]hat is not how the Commission has structured section 5 proceedings' schedules, however. To otherwise require participants to file proposals prior to reviewing the competing proposal of the pipeline is inefficient and unduly prejudicial to those participants. Reversal of the filing order would recognize that the advantaged pipeline needing only to make a just and reasonable proposal (and not attack or otherwise rebut alternative proposals) should be the first to file evidence.[45]

33. BP argues the *ANR* decisions relied on by the Commission do not cite to any precedent for the statement that the Commission may accept a pipeline's remedial proposal as just and reasonable, irrespective of whether other participants' proposals were also just and reasonable. Further, BP asserts in *ANR* the Commission in fact evaluated all the evidence presented as well as proposals from other shippers and did not automatically adopt any proposal by the pipeline deemed to be just and reasonable.[46]

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[45] BP Request for Rehearing at 30-31.

[46] BP Request for Rehearing at 32 (citing, *ANR Pipeline Co.*, 109 FERC ¶ 61,138 at PP 44, 53; *ANR Pipeline Co*., 107 FERC ¶ 63,006, at PP 59-65 (2004). Similarly, BP argues that in *ANR II*, 110 FERC ¶ 61,069, the Commission, *inter alia*, evaluated the record evidence and upheld a proposal of the pipeline stating that the pipeline's proposal was "likely to produce *a more accurate projection*" compared to a proposal made by one of the participants. *Citing*, *id.* P 51.

34. BP also argues that the *PJM Interconnection* case cited in Opinion No. 486-E involved a contested settlement which distinguishes it from the instant case. Moreover, BP argues that rather than adopting the utility's proposal without reflection, the Commission found that the settlement provisions proposed by the Settlement was just and reasonable and that it had been found acceptable to the vast majority of the parties.[47] Therefore, BP argues that these decisions cited by Opinion No. 486-E are either distinguishable or fail to support the Commission's contentions.

35. BP asserts that the Commission may not grant an undue preference to the remedial positions advanced now by Kern River because NGA section 5 directs the Commission to eradicate any undue discrimination and preference. Accordingly, BP requests rehearing concerning the determination that, under NGA section 5, the Commission may adopt any proposal of Kern River deemed just and reasonable even if other proposals made by other participants in this proceeding also would be just and reasonable.

Commission Determination

36. The Commission denies rehearing on this issue. As the Commission made clear in Opinion No. 486-E, Kern River, like any other party proposing a remedy in a section 5 proceeding, has the burden of producing sufficient evidence in support of its proposed remedy to enable us to satisfy our burden of persuasion under NGA section 5 that the remedy we adopt is just and reasonable.[48] It is only where the pipeline satisfies us that its proposed remedy is just and reasonable that we will adopt that remedy in preference to other just and reasonable remedies proposed by other parties. The Commission continues to find that such a limited preference for the pipeline's proposed remedy is consistent with the structure of the NGA.

37. The courts have long recognized that there is no single just and reasonable rate, but instead that various rates may be just and reasonable.[49] The NGA gives

[47] *PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,331, at P 85 (2006).

[48] Opinion No, 486-E, 136 FERC ¶ 61,045 at P 38.

[49] *Permian Basin Area Rate Cases,* 390 U.S. 747, 767 (1968). *Consolidated Edison Co. v. FERC*, 165 F.3d 992, 998, 1002-1004 (D.C. Cir. 1999), *aff'g, Tennessee Gas Pipeline Co., Opinion No. 406-A,* 80 FERC ¶ 61,070, at 61,223-4 (1997). *See also Cities of Bethany v. FERC,* 727 F.2d 1131, 1138, 234 U.S. App. D.C. 32 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 917, 105 S. Ct. 293, 83 L. Ed. 2d 229 (Cities); *Alabama Electric Cooperative, Inc. v. FERC,* 684 F.2d 20, 27, 221 U.S. App. D.C. 246 (D.C. Cir. 1982)

the pipeline the primary initiative, through a section 4 filing, to propose its rates, terms, and conditions of service.[50] If the pipeline's proposal is just and reasonable, the Commission must accept it, regardless of whether other just and reasonable rates, terms, and conditions of service may exist.[51] Here, the Commission is acting under NGA section 5, not section 4. However, just as there may be several just and reasonable rates, terms, or conditions which a pipeline may propose in a section 4 proceeding, there may be several just and reasonable rates, terms or conditions which the Commission may adopt as a just and reasonable remedy in a section 5 proceeding. If the pipeline supports one such just and reasonable remedy, the Commission finds that adopting the pipeline's remedy, in preference to other possible remedies, properly recognizes the NGA's policy of giving pipeline's the primary initiative to establish their rates, terms, and conditions of service.

38. BP contends that, when presented with several just and reasonable remedies, the Commission must evaluate all proposed remedies in search of the "best possible remedy,"[52] even if the Commission determines that the pipeline's suggested remedy is just and reasonable. BP appears to be suggesting that, while the pipeline's proposed remedy may be just and reasonable, the Commission might find a remedy proposed by another party to be more just and reasonable. Even assuming the Commission could thus distinguish between relative levels of justness and reasonableness, BP's contention runs into the practical difficulty that the Commission would lack the authority under the NGA to require the pipeline to maintain the so-called "best possible remedy." The pipeline could simply file its proposed just and reasonable remedy under NGA section 4, and the NGA would then require the Commission to accept the pipeline's proposal, regardless of the

[50] *United Gas Pipe Line Co., v. Mobile Gas Service Corp*., 350 U.S. 332, 340-1 (1956) (Sections 4(d) and (e) and 5(a) of the NGA "are simply parts of a single statutory scheme under which all rates are established initially by the natural gas companies . . . and all rates are subject to being modified by the Commission upon a finding that they are unlawful."). *Public Service Commission of New York v. FERC*, 642 F.2d 1335, 1343-4 (D.C. Cir. 1980). *ANR Pipeline Co. v. FERC*, 771 F.2d 507, 513 (D.C. Cir. 1985) ("The policy of the NGA [is] to have rates set by pipelines, to be set aside and replaced by the Commission only when the privately-ordered rates are unreasonable."). *Consolidated Edison Co. v. FERC*, 165 F.3d at 1002 (The NGA grants the "primary initiative for rate-setting to the pipeline.").

[51] *Western Resources, Inc. v. FERC,* 9 F.3[d] 1568, 1578 (D.C. Cir. 1993).

[52] BP Rehearing Request at 35.

Commission's preference for a different just and reasonable remedy. As the Supreme Court stated in *United Gas Co. v. Mobile Gas Corp.*,[53] sections 4 and 5 of the NGA are "parts of a single statutory scheme under which all rates are established initially by" the pipeline. It is thus reasonable for us to exercise our responsibilities under NGA section 5 in manner that is consistent with the overall structure of the NGA, including the pipeline's "initial rate-setting powers"[54] under NGA section 4.

39. BP argues that the Commission's policy of adopting a just and reasonable remedy supported by the pipeline in preference to other possible just and reasonable remedies is not consistent with the Commission's NGA section 5 obligation to eradicate any undue discrimination and states that the Commission may not grant an undue preference to the pipeline's proposal. However, this overlooks the fact that the Commission must first find, based upon the record evidence, that the pipeline's proposal is just and reasonable. Such a determination would encompass a finding that the proposal adequately remedies any undue discrimination and or preference.[55] Moreover, as already discussed, the Commission's preference for a just and reasonable remedy supported by the pipeline, far from being "undue," as claimed by BP, is thoroughly grounded in the structure of the NGA. Although BP maintains that the Commission must evaluate all proposals for a just and reasonable rate on a level playing field and select the best possible remedy, such a suggestion is not supported by section 5 of the NGA. Pursuant to section 5 of the NGA, once the Commission has determined that the underlying rate is unjust and unreasonable, the Commission's sole remaining obligation is to "determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed . . .."[56] The courts have left the manner in which the Commission determines such a rate to the Commission, and BP has not cited any cases where the court has required the Commission to ignore the pipeline's preferences in determining a remedy in a section 5 proceeding as sought by BP.[57]

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[53] 350 U.S. at 341.

[54] *Id*.

[55] *See, e.g. ANR II*, 110 FERC ¶ 61,069 at P 49 (Therefore, t*o the extent ANR's proposed remedy is just and reasonable*, the Commission will accept ANR's proposal even if other remedial provisions might also be just and reasonable.) (emphasis added).

[56] 15 U.S.C. § 717d(a).

[57] BP contends that, if the Commission is going to accept a pipeline's

40. Lastly, BP also takes exception with the Commission's citation to its orders in two *ANR* proceedings where the Commission stated its policy of adopting the pipeline's proposed remedy if shown to be just and reasonable, even if other just and reasonable remedies existed. BP asserts that in the two *ANR* proceedings, the Commission considered not only the remedy proposed the pipeline but also the remedies proposed by other parties, and the Commission did not automatically adopt any proposal by the pipeline as just and reasonable. For example, BP states that in the *ANR* proceedings, the Commission imposed additional conditions on the pipeline, thus signaling that the pipeline's "unadulterated" proposal was not just and reasonable.[58] BP also states that the Commission explained why the accepted parts of *ANR*'s proposals were preferable to the proposals of the other parties.

41. Contrary to BP's suggestion, in this case, as in the *ANR* proceedings, the Commission has carefully considered the merits of all the competing remedial proposals and has not automatically adopted Kern River's proposed remedy. In fact, the Commission rejected Kern River's proposal to include compressor cost additions in its Period Two rates, its proposed reduced rate design volumes, and its proposed increased return on equity. In addition, while the Commission accepted Kern River's proposal to require Period One shippers to enter into Period Two contracts with terms of either 10 or 15 years and to levelize the remaining balance of its original capital investment over the terms of those contracts, the Commission imposed an additional condition on Kern River. Specifically, in response to shipper concerns, the Commission required that, at the end of the Period Two contracts, Kern River offer the Period Two shippers stepped-down Period Three rates, reflecting removal from Kern River's rate base of all its original invested capital. The Commission also ordered Kern River to include in its tariff a requirement that it file *pro forma* tariff sheets setting forth proposed Period Three rates at least two years before the end of Period Two so that the Commission could set the level of those rates by the end of Period Two. Thus,

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section 5 remedial proposal in preference to just and reasonable remedial proposals by other parties, it should require the pipeline to file its proposal and supporting evidence before the other participants present their proposals at the hearing. BP argues that requiring the other participants to go first is inefficient and prejudicial to them. There is no need to address this contention in this proceeding, because the parties here agreed that Kern River and all other participants would file each round of testimony simultaneously. *Kern River Transmission Co*., 131 FERC ¶ 63,006 (2010).

[58] BP Rehearing Request at 32.

similar to *ANR*, the Commission found that Kern River's "unadulterated" contract duration/levelization period proposal was not just and reasonable.

42. In addition, the Commission evaluated the benefits and disadvantages of contract duration/levelization period proposals of all parties. The primary difference between the proposals was that Kern River proposed to levelize its remaining original investment over the terms of the Period Two contracts, but the shippers proposed to levelize those costs over the remaining depreciable life of the Kern River system. The Commission recognized that Kern River's proposal meant that annual depreciation amounts "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."[59] On the other hand, the Commission reasoned that Kern River's proposal would permit "Kern River's rate base [to] decline[s] faster, reducing the return on equity and associated income taxes that the shippers would otherwise pay over that period." [60]

43. The Commission also determined that if the proposals advanced by Kern River shippers' were adopted, the shippers "would have to wait until at least October 31, 2039, and . . . probably longer, before they would be entitled to Period Three rates."[61] The Commission explained that, if the Period Two levelization period must extend to the end of Kern River's depreciable life, it was likely that in every future Kern River rate proceeding, the Period Two levelization period would be extended into the future, indefinitely postponing the Period Three step-down rates. The Commission reasoned that such a result would be contrary to the anticipation in the original certificate proceeding that Kern River would have an opportunity to recover its invested capital in approximately 25 years, including a 10-year Period Two, and, thereafter, shippers would pay reduced Period Three rates.[62]

44. Therefore, contrary to BP's suggestion, the Commission did not reach its determination to adopt Kern River's contract duration/levelization period remedial proposal without the evaluation of the shippers' proposals. In fact, the Commission took that same approach to the contract duration/levelization issue in this proceeding, as it did with respect to the parties' proposals concerning how to project ANR's fuel use in *ANR II*. In that case, the Commission held that ANR's

[59] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 64.

[60] *Id*.

[61] *Id*.

[62] *Id*. P 66.

lack of a true-up mechanism in its fuel cost tracker was unjust and unreasonable. As part of its proposed remedy, ANR proposed to modify its method of projecting fuel use for the next year in each annual tracking filing. ANR proposed to project fuel use based on actual fuel use during the preceding calendar year, instead of its existing method of projecting fuel use based on actual fuel use data for the preceding three years. The Commission accepted this aspect of ANR's proposal over the objection of a shipper, finding that ANR's proposal was just and reasonable, "even though it might also be just and reasonable to continue use of three year . . . average."[63]

45. BP claims that the Commission actually found that ANR's proposed change in its method of projecting fuel use was preferable to its prior multi-year method, because the Commission stated that use of the most recent calendar year data "is likely to produce a more accurate projection of actual use during the next year."[64] However, this did not amount to a finding that ANR's prior multi-year method was unjust and unreasonable. In fact, in a subsequent *Texas Gas* case, the Commission accepted the pipeline's proposal to project fuel use based on a multi-year prior period, finding that "use of a longer historical period should decrease rate volatility when calculating and projecting fuel retention percentages for the next twelve month period."[65] In short, in both *ANR II* and *Texas Gas*, the Commission found that use of either a one-year or multi-year historical period to project fuel use was just and reasonable, and therefore in each case, the Commission allowed the pipeline to pick the just and reasonable method it preferred. In this case, we have followed the same approach, and approved Kern River's proposed remedy, to the extent it can show its proposed remedy is just and reasonable.

B. Levelization Period and Contract Duration

46. Opinion No. 486-E affirmed the ALJ's adoption of Kern River's proposal that (1) Period One shippers would be offered the option of entering into 10 or 15-year contracts for service during Period Two and (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.[66] However, the Commission required that, at the end of those contracts,

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[63] *ANR II*, 110 FERC ¶ 61,069 at P 51.

[64] *Id*.

[65] *Texas Gas Transmission, LLC,* 120 FERC ¶ 61,186, at P 36 (2007) (*Texas Gas*).

[66] ID, 135 FERC ¶ 63,033 at P 1037.

the Period Two shippers must be offered service at stepped-down Period Three rates, reflecting removal from Kern River's rate base of all its original invested capital.[67]

47. The Commission found that Kern River had shown that its proposal was just and reasonable. Therefore, the Commission adopted that proposal in preference to any other just and reasonable remedies that may have been proposed by other parties. Kern River's shippers did not object to the requirement that they enter into Period Two contracts with durations of either 10 or 15-years. However, they objected to Kern River's proposal to levelize its recovery of the remaining 30 percent of its original invested capital over the terms of those contracts, so that each Period Two shipper would pay its full share of the remaining 30 percent of original invested capital by the expiration date of its Period Two contract. The expiration dates of those contracts will range from (1) September 30, 2021, for Original System shippers who choose 10-year contracts to (2) April 30, 2033 for 2003 Expansion Shippers who choose 15-year contracts. Kern River's shippers contended that, instead, the Commission should require Kern River to levelize its recovery of the remaining 30 percent of its invested capital over its entire remaining depreciable life, which the Commission held earlier in this proceeding extends until October 31, 2039.

48. Opinion No. 486-E held that Kern River's levelization proposal would return its excess Period One recovery of invested capital to the Period One shippers, consistent with the rate design principles established by the orders approving Kern River's optional certificate. The Commission recognized that the shorter levelization periods proposed by Kern River require Period Two shippers to pay a higher annual amount of depreciation than if the Commission required Kern River to use the longer levelization period extending to October 31, 2039, as advocated by the shippers. On the other hand, the Commission found that a shorter 10 or 15-year levelization period provides Kern River's shippers two offsetting benefits. First, Kern River's rate base will decline faster, reducing the return on equity and associated income taxes that the shippers would otherwise pay during Period Two. Second, as Opinion No. 486-E clarified, the Period Two shippers will be entitled to stepped-down Period Three rates reflecting the removal of all of Kern River's original invested capital from its rates at the end of their 10 or 15-year Period Two contracts, rather than having to wait until at least October 31, 2039. In order to ensure the availability of stepped-down Period Three rates upon the expiration of Period Two, the Commission required that Kern River include in its tariff a provision that, on or before two years before the end of

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[67] *Id.*

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.

49. Opinion No. 486-E recognized that the orders approving Kern River's optional certificate anticipated that Period Two would cover the last 10 years of Kern River's then anticipated 25-year depreciable life, after the expiration of the shippers' original 15-year Period One contracts. However, the Commission nevertheless found that Kern River's proposal to use levelization periods shorter than its current depreciable life was reasonably consistent with the rate design principles approved in the original certificate proceeding. First, the Commission pointed out that, since the original certificate proceeding, Kern River's anticipated depreciable life has lengthened to about 49 years (from 1990 to October 31, 2039), almost double the originally predicted 25-year life. 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.[68] Therefore, Opinion No. 486-E found that, if the rate design principles established in the original certificate proceeding were interpreted as mandating that Period Two always extend to the end of Kern River's depreciable life, 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.

50. Second, Opinion No. 486-E found that Kern River's proposed levelization periods were consistent with shippers' reasonable expectations at the time of the

[68] *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 ¶ 61,164, at 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 (2012).

original certificate proceeding. At that time, the parties expected to pay rates recovering the remaining 30 percent of Kern River's costs over a 10 year period. In fact, Opinion No. 486-E pointed out that, 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 Original System shippers, it is 50 percent longer than the 10-year duration of Period Two expected at the time of the original certificate proceeding.

51. Third, Opinion No. 486-E found that the shippers had not offered any evidence concerning any contractual agreements with Kern River or other understandings at the time of the original certificate proceeding or subsequently that provided that the levelization period for Period Two would extend for the entire depreciable life of Kern River regardless of future extensions of that life.

52. Fourth, Opinion No. 486-E affirmed the ALJ's holding 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 ALJ found that the Original Certificate Order that initially approved levelized rates recognized that shippers' service agreements were synchronized with their respective levelization periods,[69] and therefore the shippers on the Kern River system understood from the outset the importance of corresponding contract and levelization periods. The Commission agreed with the ALJ's findings that, if the levelization period extended beyond the duration of the Period Two contracts, Kern River might be precluded from recovering all of the depreciation expense upon which the Period Two rates are predicated. 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.

53. Finally, Opinion No. 486-E rejected the shippers' contentions that Kern River's Period Two levelization proposal is contrary to findings in earlier opinions in this rate proceeding. The Commission explained that Opinion No. 486-C established a hearing on this issue, and nothing said in earlier orders in the Opinion No. 486 series was intended to decide the issue.

Requests for Rehearing

54. Only BP, as joined by NVE, requests rehearing of the Commission's approval of Kern River's proposal to levelize its recovery of the entire 30 percent of its invested capital remaining at the end of Period One over the agreed-upon 10

[69] ID, 135 FERC ¶ 63,003 at P 1041.

or 15-year terms of the shippers' Period Two contracts.[70] Kern River's other shippers have not sought rehearing on this issue.

55. On rehearing, BP argues that Opinion No. 486-E erroneously approved 10-year and 15-year levelization periods for Period Two. BP asserts that this finding is inconsistent with Commission precedent that Kern River's Period Two rates are to be levelized over Kern River's remaining depreciable life and that Kern River itself understood Period Two would extend through at least 2032 as can be seen through its statements during the ET Settlement proceedings.[71] BP argues, therefore, that the Commission's determination on this matter is inconsistent with prior Commission precedent and reasoned decision-making, is arbitrary and capricious, not based upon substantial evidence, and constitutes legal error.

56. Second, BP argues that Opinion No. 486-E erred with respect to the determination that the length of Period Two must be coterminous with the 10-year or l5-year contracts entered into by Period Two shippers. BP argues that this finding is inconsistent with Commission precedent that Period Two contracts need not be of the same duration as the levelization period used by the pipeline to derive rates.[72] BP asserts that Kern River will have substantial net regulatory liabilities, rather than regulatory assets, as of the beginning of each shipper's Period Two, and it maintains that this is a distinction between Periods One and Two that was not adequately analyzed in Opinion No. 486-E. Therefore, BP asserts that Opinion No. 486-E erred in its determinations of this matter.

<u>Commission Determination</u>

57. In this proceeding, the Commission is acting under NGA section 5 to develop just and reasonable rates for Kern River to charge its firm shippers during Period Two, after the expiration of their Period One levelized rate contracts. As previously described, Kern River's Period One rates were designed to recover 70 percent of its original invested capital, even though it would not have reached 70

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[70] In its Request for Rehearing, NVE states that it adopts the arguments of BP in regard to these issues.

[71] BP Request for Rehearing at p. 4, (citing, Opinion No. 486, 117 FERC ¶ 61,077 at P 19. *See also* Opinion No. 486-C, 129 FERC ¶ 61,240 at P 3; Opinion No. 486-B, 126 FERC ¶ 61,034 at PP 2, 168, n.275, P 188; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 2; Opinion No. 486, 117 FERC ¶ 61,077 at P 15 n.32; *ET Settlement Order*, 92 FERC at 61,159, *reh'g denied*, 94 FERC ¶ 61,116).

[72] BP Request for Rehearing at p. 5 (citing, Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 171-172; Opinion No. 486-C, 129 FERC ¶ 61,240 at P 254).

percent of its depreciable life at the end of Period One. Therefore, Kern River's Period Two rates must be designed both to (1) allow Kern River to recover the remaining 30 percent of its invested capital not recovered through the Period One rates and (2) return to its shippers its excess recovery of depreciation during Period One. In addition, in Opinion Nos. 486-C and 486-D, the Commission held that Kern River's optional expedited certificate required that the Period Two rates be levelized, and that such levelization is necessary to assure a return of the excess recovery of depreciation during Period One in a just and reasonable manner.

58. While these parameters for just and reasonable Period Two rates were established in Opinion Nos. 486 through 486-D, the Commission determined in Opinion No. 486-C that a hearing was necessary before it could resolve the issues of what levelization period to use for Period Two and what duration contracts shippers must enter into to obtain levelized Period Two contracts. At the hearing, all parties agreed that Period One shippers would be required to enter into contracts of either 10 or 15 years duration in order to be eligible for Period Two levelized rates. Moreover, all shippers other than BP and NVE have accepted Opinion No. 486-E's approval of Kern River's proposal to levelize its recovery of the remaining 30 percent of its invested capital over the agreed-upon 10 or 15-year terms of the shippers' Period Two contracts, subject to the condition that, at the end of those contracts, Kern River must offer the Period Two shippers service at stepped-down Period Three rates, reflecting removal from Kern River's rate base of all its original invested capital.

59. BP and NVE contend, however, that we should require Kern River to levelize its remaining original invested capital over its entire remaining depreciable life, which the Commission has found in this proceeding will extend until October 31, 2039. Both BP and NVE were shippers on Kern River's Original System who entered into extended term 10-year Period One contracts which expired on September 30, 2011. Accordingly, under their proposal, they would be permitted to enter into 10 or 15-year Period Two contracts for service on the Original System, expiring on either September 30, 2021 or September 30, 2026, while Kern River would be required to levelize those shippers' allocated share of the remaining 30 percent of its invested capital in the Original System over a 28-year period extending until October 31, 2039. BP also has a 10-year Period One contract for service on the 2003 Expansion, which expires on April 30, 2013. Thus, its proposal would permit it to enter into 10 of 15-year contracts for service on the 2003 Expansion, expiring on either April 30, 2023 or April 30, 2028.

60. 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 proposal to levelize its recovery of the entire 30 percent of its invested capital remaining at the end of Period One over the agreed-upon 10 or 15-year terms of the shippers' Period Two contracts is just and reasonable, we will adopt that proposal in preference to other just and reasonable remedies that may have been proposed by other parties, such as BP and NVE. For the reasons discussed below, we find that Kern River has shown that its levelization proposal is just and reasonable and consistent with the rate parameters established in Opinion Nos. 486 through 486-D described above. Therefore, we deny BP and NVE's requests for rehearing.

61. In the first section below, we find that Kern River's proposal is just and reasonable, so long as the rate design principles adopted in the optional expedited certificate proceeding and carried forward in the ET Settlement contain no requirement that Kern River levelize its recovery of its remaining investment over the 28-year remainder of its depreciable life as of the expiration of BP and NVE's Period One contracts. In the second section below, the Commission finds that Kern River's proposal is consistent with the rate design principles adopted in the optional expedited certificate proceeding. In the third section below, the Commission finds that nothing in the subsequent ET Settlement or other orders of the Commission requires Kern River to levelize its remaining investment over a 28-year period while permitting BP and NVE to contract for only 10 or 15 years of service.

<u>Reasonableness of Competing Levelization/Contract Duration Proposals</u>

62. In assessing the justness and reasonableness of the competing proposals by Kern River on the one hand and BP and NVE on the other concerning the coordination of the length of the Period Two levelization period with the duration of the Period Two contracts, it is important to understand the differences between a traditional rate design and a levelized rate design.

63. Under a traditional rate design, the Commission includes in the pipeline's cost of service an annual depreciation allowance based on the straight line depreciation rate the Commission has approved for use in the pipeline's accounts pursuant to NGA section 9 (book depreciation rate). The Commission also includes in the pipeline's cost of service a return based on the pipeline's net invested capital[73] at the end of the test period. Thus, the Commission designs rates which provide the pipeline a reasonable return on its actual net invested capital devoted to the provision of jurisdictional services during the first year the

[73] Original investment minus accumulated depreciation and adjustments for deferred income taxes.

rates are in effect, and allows the pipeline to recover its invested capital on an even annual basis for the depreciable life of the pipeline. If and when the pipeline files a subsequent NGA section 4 rate case, the rate base is reduced by the accumulated depreciation expense collected by the pipeline under the prior rates. This reduces the return included in the pipeline's cost of service in the new rate case, consistent with the reduction in the pipeline's actual net investment devoted to the provision of jurisdictional service. Therefore, under traditional ratemaking, the pipeline's rates are higher during the early years of the pipeline's life and then gradually decline in each subsequent rate case, unless the pipeline makes new rate base investments.

64. Unlike a traditional rate design, a levelized rate design is intended to produce rates at approximately the same level throughout the life of the pipeline, with the result that a levelized rate is lower than a traditional rate during the early years of the levelization period, but a levelized rate is higher than a traditional rate during the later years. In essence, levelization is accomplished by the pipeline deferring to later years recovery of costs that would otherwise be recoverable early in the levelization period. Kern River's levelized rate calculations accomplish rate levelization by varying the amount of depreciation included in its rates from year to year.[74] Specifically, annual depreciation recovery in rates starts very low and increases during the levelization period as the return component of the levelized rate decreases, in tandem with the decreasing rate base, to obtain a constant annual cost of service.[75] Thus, in the early years of the levelization period, regulatory depreciation (i.e. the amount of depreciation expense included in rates) is less than the straight-line depreciation recorded in its books, and in the later years regulatory depreciation is higher.

65. During periods when regulatory depreciation is less than book depreciation, the difference between the two is recorded in the pipeline's accounts as a regulatory asset, if it is probable the pipeline will recover the amount in future

[74] Exhibit No. KR-P2-3 at 4.

[75] As explained in the *Kern River Gas Transmission Co*., 58 FERC ¶ 61,073 at 61,244 n.38 (1992) (Amended Certificate Order), the varying plant cost recovery are analogous to the principal repayment on a fixed rate mortgage on a house. In the early years of the mortgage most of the payment is applied to the interest and very little goes toward the principal, whereas in the latter years most of the payment goes toward the principal, and the interest portion is relatively small.

rates.[76] When regulatory depreciation is more than book depreciation, the difference is recorded as a regulatory liability. The amounts recorded in the regulatory asset or liability accounts are extinguished as the amounts collected in rates exceed (or are less than) amounts recorded for accounting purposes.

66. The deferral of the pipeline's recovery of its depreciation expense under rate levelization means that, during the first half of the rate levelization period, the average rate produced by rate levelization is not sufficient to produce a reasonable return on the pipeline's actual net invested capital devoted to jurisdictional service during those years. At the start of the levelization period, the pipeline's net invested capital devoted to jurisdictional service includes its entire starting rate base (minus any regulatory liability). As the pipeline recovers its depreciation expense, the pipeline's net invested capital, as represented by the rate base, gradually declines. Because a reasonable return is a percentage of the rate base, the dollar amount required to provide a reasonable return on the pipeline's net invested capital is higher during the first half of the levelization period when its rate base is higher, than during the second half when its rate base is lower. However, the deferral of the pipeline's recovery of its depreciation expense to the later years of the levelization period inevitably results in an overall rate that is too low during the first half of the levelization period to recover both the pipeline's actual cost of service including depreciation expense and a reasonable return on its net invested capital devoted to jurisdictional service during that period. This cost underrecovery is then recouped during the second half of the levelization period when the levelized rates are higher than necessary to recover the pipeline's actual costs during that time.

67. The benefit of levelized rates is that they provide shippers lower rates during the early part of the levelization period than traditional rates. This helps the pipeline market its capacity, and, for this reason, pipelines have offered levelized rates when seeking customers for a new pipeline project, as Kern River has done.[77] However, as explained above, levelized rates also entail the pipeline reducing its rates during the early years of the levelization period below the level

[76] *See Revisions to Uniform System of Accounts for Allowances Under the Clean Air Amendments of 1990 and Regulatory-Created Assets and Liabilities and to form No. 1, 1-F, 2 and 2-A*, Order No. 552, FERC Stats. & Regs. Regulations Preambles January 1991-June 1996 ¶ 30,967, at 30,826 (1993).

[77] *See Ingleside Energy Center, LLC*., 112 FERC ¶ 61,101, at PP 76-78 (2005) (*Ingleside*); *Corpus Christi*, 111 FERC ¶ 61,081, at PP 30-32 (2005) (*Corpus Christi*); and *Questar Southern Trails Pipeline Co*., 89 FERC ¶ 61,050, at 61,147 (1999) (*Questar Southern Trails*).

necessary to provide a reasonable return on its actual investment devoted to jurisdictional service during the early years in return for the ability to recoup that cost deferral through higher rates during the later years of the levelization period.

68. Because this trade-off is at the heart of any levelization plan, pipelines agreeing to use levelized rates for a new project have generally done so in conjunction with a contractual commitment by the shippers to take service beyond the initial period when the levelized rate is below the level necessary to provide a reasonable return on the actual outstanding capital the pipeline has invested in providing service.[78] In addition, the Commission has held that, absent such a contractual commitment, the pipeline may not record the amount by which book depreciation exceeds regulatory depreciation as a regulatory asset in its accounts kept pursuant to the Uniform System of Accounts.[79] While Opinion No. 486-C held that Commission policy permits pipelines to use levelized rates without obtaining contractual commitments from their shippers to take service for most or all of the levelization period,[80] it does not follow that it is just and reasonable to require a pipeline to provide levelized rates without any such commitment when the pipeline desires to condition the offer of levelized rates on a requirement that the shippers commit to taking service for most or all of the levelization period.[81] Because a levelized rate is below the level necessary to provide a reasonable

[78] *See AES Ocean Express, LLX*, 103 FERC ¶ 61,030 at PP 6, 29 (2003) (25-year contract term with 25-year levelization period); *Tractebel Calypso Pipeline, LLC*, 103 FERC ¶ 61,106 at PP 10, 29 (2003) (20-year contract with 20-year levelization period); *Ingleside*, 112 FERC ¶ 61,101 at P 76-78 (15-year contract term, with 20-year levelization period); and *Corpus Christi*, 111 FERC ¶ 61,081 at PP 30-32 (20-year contract term, with Commission requirement to use a 20-year levelization period).

[79] *Ingleside*, 112 FERC ¶ 61,101 at P 78; and *Questar Southern Trails*, 89 FERC at 61,147.

[80] For example, as the Commission pointed out in Opinion No. 486-C, 129 FERC ¶ 61,240 at PP 255-256, in *Questar Southern Trails*, 89 FERC at 61,147, the Commission approved the pipeline's proposal to use a 25-year levelization period, even though its shippers' contracts were for only five or ten years.

[81] As Opinion No. 486-C noted, in *Ozark Gas Transmission System*, 50 FERC ¶ 61,252 (1990); and *Trailblazer Pipeline Co.*, 50 FERC ¶ 61,188 (1990), the Commission required the pipelines to implement levelized rates to ensure that their shippers received the benefit of their declining rate bases. However, in those cases, the pipeline did not raise any concern that the levelization period might be significantly shorter than the terms of their shippers' contracts.

return on the actual outstanding capital the pipeline has invested in providing service during the first half of the levelization period, the Commission finds that a pipeline may reasonably condition its agreement to offer levelized rates on a contractual commitment by the shipper to take service beyond that period. In fact, Kern River did just this when it contracted with its shippers for service during Period One.

69. When Kern River constructed its Original System, shippers were required to enter into contracts for the entire 15 year period over which Kern River's recovery of 70 percent of its initial investment in constructing its system was levelized. As a result, those contracts permitted Kern River to recover a reasonable return on its net invested capital devoted to jurisdictional service during that period. In fact, because those contracts also permitted Kern River to recover somewhat more of its depreciation than was attributable to that period under a straight-line depreciation, Kern River would have a regulatory liability recorded on its books, rather than a regulatory asset. Similarly, Kern River's ET Settlement required its shippers to extend their Period One contracts by ten or fifteen years in order to obtain reduced Period One rates based on a correspondingly longer levelization period.[82] Therefore, Kern River expected that at the end of the shippers extended term contracts, it would have no unrecovered regulatory assets on its books.[83]

70. Kern River's proposal to levelize its recovery of the entire 30 percent of its invested capital remaining at the end of Period One over the agreed-upon 10 or 15-year terms of the shippers' Period Two contracts is consistent with these principles. By synchronizing the Period Two rate levelization period with the duration of the shippers' Period Two contracts, Kern River's proposal reasonably requires shippers to take service not only when the levelized rates are lower than traditional rates but also when levelized rates are higher than traditional rates. The requirement to enter into contracts for the entire Period Two levelization period is also consistent with the same requirement imposed on shippers in Period One.

[82] Original Shippers who extended their contracts for ten years ended up with Period One contracts with a total duration of 19 years, and shippers who extended their contracts by 15 years ended up with Period One contracts with a total duration of 24 years. These contract durations represented 47.5 percent and 60 percent of Kern River's revised depreciable life of 40 years, and those contracts required each set of shippers to pay 70 percent of Kern River's original invested capital.

[83] May 24, 2000 Kern River filing in Docket No. RP00-298-000 at 7.

71. By contrast, BP and NVE's proposal would require Kern River to use a 28-year Period Two levelization period for Original System shippers with contracts expiring September 30, 2011, while permitting them to enter into Period Two contracts for only 10 or 15 years. Unlike the requirement in Period One that shippers enter into contracts for the entire levelization period, a 10-year Period Two contract under BP and NVE's proposal would only require BP and NVE to pay levelized rates for the first 35.7 percent of their proposed levelization period and a 15 year contract would only require them to pay levelized rates for the first 53.6 percent of the levelization period.[84] This would effectively permit BP and NVE to obtain the benefits of the lower rates provided by levelization during the first half of the levelization period, with little or no commitment to take service during the second half of the levelization period when the levelized rate is higher than a traditional rate.

72. The Commission finds this to be an unreasonable result, unless it can be found that Kern River agreed to this result when it decided to proceed with construction of its system pursuant to the conditions established in its optional expedited certificate. Consistent with the discussion above, Kern River's rates during the first half of BP and NVE's proposed levelization period would not provide Kern River a reasonable return on its actual invested capital devoted to providing service to BP and NVE during that period. As a result, BP and NVE's proposal would leave Kern River with a substantial unrecovered regulatory asset at the end of their contracts. It is not reasonable to require Kern River to provide Period Two service at rates which do not provide a reasonable return for the period in question, without a commitment from the shipper to take service during the later period when the pipeline is able to recoup its loss during the earlier period, unless Kern River has previously bound itself to do so in the optional expedited certificate proceeding or the ET Settlement.

73. BP argues that, because of the accelerated recovery of depreciation during Period One, Kern River accrued a regulatory liability that must be returned to its shippers. Therefore, BP asserts that Opinion No. 486-E erred to the extent it determined that Kern River might be precluded from recovering its depreciation expense if Period Two contracts are shorter than the Period Two levelization

[84] The results for the 2003 Expansion are similar. A 10-year Period Two contract for service on the 2003 Expansion would only require BP to pay levelized rates for the first 37.7 percent of their proposed levelization period and a 15 year contract would only require it to pay levelized rates for the first 56.6 percent of the levelization period.

period.[85] It asserts that, rather than Kern River recovering any remaining deferred regulatory asset, the issue is instead Kern River's return of the regulatory liability.

74. The Commission finds that the fact Kern River has a regulatory liability at the end of Period One does not mean that the sole concern in designing Kern River's Period Two rates is the return of the regulatory liability. Kern River's starting Period Two rate base for purpose of determining the return on equity to be included in its Period Two rates is determined by subtracting (1) the regulatory liability resulting from Kern River's accelerated recovery of depreciation during Period One from (2) the 30 percent of its original invested capital to be recovered during Period Two.[86] Levelized Period Two rates are then designed which reflect the decline in the resulting net starting rate base to zero by the end of the levelization period. The reduction in the starting rate base by the amount of the regulatory liability allows the shippers to start benefitting from that liability immediately upon the commencement of Period Two, because it serves to reduce the return on equity that would otherwise be included in the levelized rates throughout Period Two.[87]

75. In order to levelize Kern River's Period Two rates after the removal of the regulatory liability from the starting rate base, Kern River's rate levelization methodology requires that it defer recovery of a substantial portion of its depreciation expense to the last half of the levelization period. As a result, Kern River's regulatory depreciation will be less than its book depreciation during the first half of the levelization period. This means that, under BP and NVE's proposal, Kern River would have a substantial unrecovered regulatory asset at the end of their 10 or 15-year contracts. As Kern River's witness, Ms. Hausman, explained,

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[85] BP Request for Rehearing at p.15 (citing, Opinion No. 486-E, 136 FERC ¶ 61,405 at P 72).

[86] Exhibit No. KR-P2-1 at 11.

[87] This action accomplishes the need to "pay back" the accumulated regulatory liability accrued by Kern River during Period One. As the Commission stated "the fact that Kern River's Period One rates have been designed to recover more of its invested capital during that period than would have otherwise been properly allocated to that period carries with it an obligation for Kern River to return that excess recovery to its shippers during Period Two, through the step-down rates to be implemented at the start of Period Two." Opinion No. 486-D, 133 FERC ¶ 61,162 at P 158.

> Regardless of the levelization and contract periods approved for Period Two, Kern River will accrue deferred depreciation during Period Two, just as it does now, because of differences in book and regulatory deprecation. Such differences are inherent in the levelization methodology, which adjusts the amount of depreciation included in rates each year to calculate an equal cost of service for each year of the specified levelization period. The existence of a net regulatory liability at the start of Period Two does not of itself mean that allowing Period Two service agreements shorter than the Period Two levelization period would not call into question Kern River's ability to recover all Period Two deferred depreciation in its rates.[88]

76. Thus, BP is mistaken in its assertion that the existence of a regulatory liability at the end of Period One eliminates the accrual of a regulatory asset during the first half of the Period Two levelization period or undercuts the reasons discussed above why it would be unreasonable to require Kern River to offer them contracts with durations shorter than the Period Two levelization period.

77. BP also asserts that Opinion No. 486-E errs in finding that decoupling the Period Two contract terms from the levelization period would impose an unreasonable risk on Kern River. BP points out that, if a Period Two shipper leaves the system at the end of its contract, Kern River would be permitted to sell that capacity to another shipper, which is not eligible for Period Two rates, at its higher recourse rates.[89] BP therefore reasons that requiring Kern River to levelize its Period Two rates over a period longer than the Period Two shippers' contracts would provide Kern River with an opportunity to re-contract capacity at recourse rates higher than the Period Two rates if a Period Two shipper leaves the system before the end of the levelization period.

78. We recognize that, under the scenario presented by BP, Kern River might potentially recover more revenue if we adopted BP and NVE's proposal to permit them to enter into 10 or 15-year contracts while requiring Kern River to use a 28-

[88] Exhibit No. KR-P2-28 at 12.

[89] The Commission has held that, if shippers eligible for Period Two rates decide not to take service from Kern River at such rates, Kern River may offer such capacity to other shippers at its recourse rate. Opinion No. 486-E, 136 FERC ¶ 61,045 at P 98.

year levelization period. However, that does not alter the fact that BP and NVE's proposal imposes on Kern River a greater risk for recovering the deferred depreciation costs not paid by BP and NVE. Instead of having a contractual commitment from the Period Two shipper to pay rates which would enable it to recover the regulatory asset, Kern River would have to take the risk that it could find other shippers willing to pay rates at least as high as the Period Two shipper would have paid had it remained on the system. For the reasons discussed above, the Commission finds that it would not be reasonable, when acting under NGA section 5 as we are here, to require Kern River to take such a risk.

79. BP emphasizes that Kern River's proposal to levelize its recovery of the entire 30 percent of its invested capital remaining at the end of Period One over the agreed-upon 10 or 15-year terms of the shippers' Period Two contracts will enable Kern River to recover its depreciation expense before the end of its depreciable life. The end dates of the Period Two contracts could range from September 30, 2021 for Original System Shippers who choose 10-year Period Two contracts to April 30, 2033 for 2003 Expansion Shippers who choose 15-year contracts, as compared to the October 31, 2039 end of Kern River's depreciable life.

80. If BP, NVE, and other Period One shippers had been willing to offer to enter into Period Two contracts extending until the October 31, 2039 end of Kern River's depreciable life, it would be reasonable to require Kern River to offer such shippers Period Two rates levelized over its entire remaining depreciable life. Such contracts would commit the shippers to take service during the later part of the Period Two levelization period when the levelized rate is higher than a traditional rate, thus allowing Kern River to recoup its cost underecovery during the earlier part of the levelization period. Under this option, BP and NVE could have obtained Period Two rates for service on the Original System levelized over Kern River's entire remaining depreciable life by agreeing to Period Two contracts with terms extending for the entire 28-year period extending from the September 30, 2011 expiration of their Period One contracts until the October 31, 2039 end of Kern River's depreciable life. However, neither BP and NVE, nor any other Period One shipper, sought such an option, or indicated any willingness to agree to contracts with durations of the necessary length.

81. Therefore, the Commission is left with a choice between (1) BP and NVE's proposal to require Kern River to use a levelization period matching its remaining depreciable life while permitting shippers to enter into significantly shorter contracts or (2) Kern River's proposal to use a levelization period matching the terms of the shippers' Period Two contracts but significantly shorter than its depreciable life. On balance, we find that Kern River's proposal is reasonable.

82. While Kern River's shorter levelization period requires Period Two shippers to pay a higher annual amount of depreciation, than if the Commission required a levelization period matching its depreciable life, the shorter levelization period provides Kern River's shippers two offsetting benefits. First, as the Commission found in Opinion No. 486-E and BP does not contest, Kern River's rate base will decline faster, reducing the return on equity and associated income taxes that the shippers would otherwise pay during Period Two.

83. Second, the Period Two shippers will be entitled to stepped-down Period Three rates reflecting the removal of all of Kern River's original invested capital from its rates at the end of their 10 or 15-year Period Two contracts, rather than having to wait until at least October 31, 2039. Moreover, under the accounting principles discussed above, Kern River is required to record any excess of its regulatory depreciation over its straight-line book depreciation as a regulatory liability. Thus, while Kern River's proposal will allow it to recover its depreciation expense related to its original investment in its rates faster than it records that expense in its books, it will have to treat its accelerated recovery of depreciation as a regulatory liability. While the Period Two rates are designed to recover the entire remainder of its original invested capital in the Original System and the 2002 and 2003 Expansions, Kern River will continue to be making new investments in its system as discussed later in this order, particularly to replace its compressors whose depreciable life is significantly shorter than that of its system as a whole. When Kern River designs its Period Three rates, it will have to subtract the regulatory liability accrued at the end of Period Two from any new capital costs in its rate base at the end of Period Two. In this way, Kern River's accelerated recovery of depreciation during Period Two will benefit shippers in Period Three, just as its accelerated recovery of depreciation in Period One benefits shippers in Period Two.

84. Accordingly, we conclude that Kern River's proposal concerning Period Two rate levelization and contract duration is just and reasonable, so long as the rate design principles adopted in the optional expedited certificate proceeding and carried forward in the ET Settlement contain no requirement that Kern River levelize its recovery of its remaining investment over the 28-year remainder of its depreciable life as of the expiration of BP and NVE's Period One contracts. We now turn to the issue of the consistency of Kern River's proposal with those rate design principles.

Consistency with Optional Expedited Certificate

85. BP contends that "as set forth in Kern River's Original Certificate Order, and as part of the levelization bargain Kern River entered into with its shippers, Period Two should . . . run through the end of Kern River's depreciable life,"

which the Commission has found in this rate case is October 31, 2039.[90] BP argues that the rate design principles underlying Kern River's optional expedited certificate require Kern River to levelize its remaining original invested capital over its entire remaining depreciable life as it may be extended in future rate cases, while permitting BP to enter into a Period Two contract for only 10 years or 15 years.

86. The Commission agrees with BP that a key issue in determining the justness and reasonableness of Kern River's 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 whether that proposal is consistent with the rate design principles underlying its optional expedited certificate.[91] As the Commission explained in Opinion No. 486-D, in order to obtain an optional expedited certificate, the applicant had to agree to assume the economic risks of the project.[92] The rate design approved in the Commission's orders granting Kern River's optional expedited certificate was the basis for the Commission's holding that Kern River had satisfied this risk assumption requirement. Having granted Kern River its certificate on this basis, the Commission could reasonably expect Kern River to maintain the rate design that provided the basis for granting the certificate.[93]

87. However, contrary to BP's contentions, we interpret our orders in the optional expedited certificate proceeding as establishing a fixed duration for both Period One and Period Two, without any requirement that Period Two be extended to reflect subsequent changes in Kern River's book depreciation rate. As described below, in our orders in the Original Certificate proceeding, we consistently described Periods One and Two as fixed 15 and 10 year periods based on the assumed 25-year economic life of the facilities at the start of the project, without any indication that the duration of those periods was subject to change based on subsequent changes in Kern River's book depreciation rate.

[90] BP August 19, 2011 Rehearing Request at 13.

[91] *See* Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 120-137, for a full discussion of the reasons for focusing on the rate design principles approved in the orders granting Kern River's optional expedited certificate.

[92] 18 C.F.R. § 157.103(d) and § 157.104(c).

[93] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 134.

88. In the Original Certificate Order,[94] the Commission stated it was approving a similar rate structure for Kern River, as it had in granting an optional expedited certificate to the Wyoming-California Pipeline Company (WyCal) to serve the same California Enhanced Oil Recovery operations in the heavy oil fields in Kern County, California.[95] A key element of that rate structure was the assumption of a 25-year economic life for the projects. As the Commission found in *WyCal I*,

> Estimating conservatively, there would be at least a 25-year economic life for the proposed facilities based upon the natural gas reserves and reserve to production ratios in the proposed supply area. Accordingly, we believe that a 25-year economic life for the project should be assumed.[96]

The Commission used the same assumed depreciable life in Kern River's case, and permitted Kern River, like WyCal, to recover 70 percent of its invested capital during the first 15 years, with the remainder of the invested capital to be recovered during the next ten years, and the pipeline recovering only operating expenses, taxes, and a management fee thereafter.[97]

89. Kern River's Original Certificate Order redetermined the pipeline's rates consistent with these principles, stating the Commission "will authorize Kern River to charge one rate for its first 15 years of service, another rate for years 15 through 25, and a third rate for service rendered after 25 years."[98] The Commission explained:

> 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

[94] Original Certificate Order, 50 FERC at 61,150.

[95] *Wyoming-California Pipeline Co.*, 44 FERC ¶ 61,001 (1988) (*WyCal I*), *reh'g granted in part*, 45 FERC ¶ 61,234 (1988) (*WyCal II*).

[96] *WyCal I*, 44 FERC at 61,009.

[97] Original Certificate Order, 50 FERC at 61,150. *WyCal II*, 45 FERC at 61,680-1.

[98] *Id*.

> maintained at 25 years. Kern River will assume the risk of recovery of depreciation not recovered in the first 15 years. Charges for service beyond 25 years will provide for the recovery of Kern River's operating expenses taxes and a reasonable management fee that is equivalent to no more than 10 percent of Kern River's average pre-tax return.

The Commission then set forth separately the maximum rates to apply "for any services rendered during the first 15-year period," "for any services rendered during the next 10-year period, beginning 15 years after Kern River's in-service date," and "for any services rendered after 25 years from Kern River's in-service date."[99]

90. While the Period Two adopted in the Original Certificate Order corresponded to the last 10 years of the 25-year depreciation life which the Commission found in *WyCal I* "should be assumed" for these projects, nothing in the Original Certificate Order indicated an intent that the duration of Period Two be subject to change depending upon future changes in Kern River's depreciable life. To the contrary, as described above, the Original Certificate Order referred to Period Two as "Years 16 through 25" or "the next 10-year Period, beginning 15 years after Kern River's in-service date," without any reference to Period Two being tied to the duration of Kern River's depreciable life as it might change in future NGA section 4 rate cases. Similarly, the Original Certificate Order referred to Period Three as applying to "services rendered after 25 years from Kern River's in-service date," without any reference to Period Three commencing at the end of Kern River's depreciable life. Thus, the Original Certificate Order described Period Two as a fixed 10-year period, with Period Three beginning on a fixed date 25 years after Kern River's in-service date.[100]

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[99] *Id*. at 61,150-151.

[100] Similarly, in *WyCal II*, 45 FERC at 61,680-1, the Commission consistently referred to the three rate periods as fixed periods covering the first 15 years of service, years 16 to 25, and the period after 25 years, without ever suggesting an intent that the duration of the three rate periods would change depending upon future changes in the pipeline's depreciable life. For example, the Commission rejected WyCal's contention that it was premature to address its rates that would take effect after 25 years, reaffirming the Commission's decision in the certificate proceeding to "set forth the parameters for the rates that will take effect in 25 years," including that those rates will include operating expenses, taxes and a reasonable management fee. *Id*. at 61,681.

91. If the Commission had intended to require that the duration of Period Two be extended to include future extensions in Kern River's depreciable life, as BP argues, it would have been reasonable for the Original Certificate Order to include at least some mention of the possibility that the duration of Period Two was subject to such a change, with a corresponding change in the beginning of Period Three. However, there is no such mention in the Original Certificate Order.

92. The Commission's subsequent orders in Kern River's optional expedited certificate proceeding continued to treat Period Two as a fixed 10-year period, with Period Three to commence on a fixed date 25 years after Kern River's in-service date. The January 1992 Order granted Kern River's request to amend its certificate to increase its initial rates to reflect updated costs estimates of constructing its Original System. As in the Original Certificate Order, the Commission stated that it would "authorize Kern River to charge one rate for its first 15 years of service, another rate for years 16 through 25, and third rate for service rendered after 25 years." [101] The Commission also explained,

> The levelized rate structure will enable Kern River to recover substantially all of its debt capital during the first 15 years and its equity capital during the next 10 years. Charges for service beyond 25 years will provide for the recovery of Kern River's operating expenses taxes and a reasonable management fee that is equivalent to no more than 10 percent of Kern River's average pre-tax return."[102]

The Commission then again set forth separately the maximum rates to apply "for any services rendered during the 15-year period beginning on Kern River's in-service date," "for any services rendered during the 10-year period beginning 15 years from Kern River's in-service date," and "for any services rendered after 25 years from Kern River's in-service date."[103] Similar to the Original Certificate Order, the January 1992 Order contains no mention of the possibility that the duration of Period Two or the commencement date of Period Three might change depending on future changes in Kern River's depreciable life.[104]

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[101] *Kern River Gas Transmission Co*., 58 FERC ¶ 61,073, at 61,242 (1992) (January 1992 Order).

[102] *Id*.

[103] *Id*. at 61,242-3.

[104] The January 1992 Order also contains an explanation of the differences

93. Finally, in its August 1992 order,[105] the Commission partially granted rehearing of the January 1992 order, holding that the prior order had improperly maintained the 70 percent /30 percent debt to equity ratio throughout the project's life, without recognizing that the depreciation accumulated in the first 15 years would be used to retire the debt principal resulting in the project being capitalized with 100 percent equity after 15 years. While the Commission granted rehearing on this issue, it stated that it was concerned that the rate of return authorized in the certificate orders may not be appropriate in the latter years of the project. Therefore, the Commission reserved the right to examine this issue in a future general rate proceeding.[106] By contrast to the express reservation of the right to reexamine Kern River's return on equity, the August 1992 Order again contains no mention of the possibility that the duration of Period Two or the commencement date of Period Three might change based on future changes in Kern River's depreciable life.

94. The Commission concludes that, contrary to BP's contentions, nothing in the rate design principles approved in Kern River's original certificate proceeding requires the duration of Period Two to be extended to match any extensions in Kern River's depreciable life beyond the 25 years which the Commission held should be assumed in the original certificate proceeding. Nor has BP pointed to any statement in any of the Commission's orders in the Original Certificate Proceeding requiring Period Two to be so extended.

ET Settlement and Subsequent Orders

95. BP contends that, in finding that the duration of Period Two need not be extended to match any extensions in Kern River's depreciable life, Opinion No. 486-E placed too much weight on the fact that in the original certificate proceeding Kern River's depreciable life was estimated to be 25 years with a Period One of 15 years and a Period Two of 10 years. BP asserts that the Commission erroneously ignored changes in Kern River's levelization plan after the issuance of the certificate order, particularly in the ET Settlement.

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between the plant cost recoveries reflected in Kern River's levelized rates and the four percent annual depreciation rate the Commission prescribed under NGA section 9. *Id*. at 61,243-44. This discussion also treats Period Two as a fixed 10-year Period with Period Three to begin on a fixed date 25 years after Kern River's in-service date.

[105] *Kern River Gas Transmission Co.*, 60 FERC ¶ 61,123 (1992) (August 1992 Order).

[106] *Id.* at 61,437.

96. Kern River and a number of its shippers filed the ET Settlement on June 13, 2000, proposing reduced rates on the Original System, subject to conditions.[107] As the parties explained in their joint offer of the ET Settlement, the purpose of that settlement was to reduce the shippers' Period One rates on the Original System to be responsive to the competitive demands of the marketplace, particularly the market for gas-fired electric generation.[108] Kern River estimated that significant new generating capacity would be constructed in its market area by 2002, and both Kern River and its customers were eager to serve this growing market. Therefore, the parties stated, "To address this need, Kern River has developed extended-term rates to provide its firm shippers with the option to pay lower-cost, more market responsive rates starting in 2001 *in return for extending their contract terms.*"[109] The shippers' existing Original System contracts expired in 2007. The ET Settlement provided the shippers the option to extend their contracts for either a 10-year term from October 1, 2001 through September 30, 2011 or a 15-year term from October 1, 2001 through September 30, 2016. Shippers exercising that option would pay levelized rates designed to complete Kern River's recovery of 70 percent of its invested capital in the Original System over the extended terms of the contracts, with shippers choosing the 10-year option receiving a 27 percent rate reduction and shippers choosing the 15-year option receiving a 34 percent rate reduction. The parties also stated that "implementation of the extended-term rates will require a change in Kern River's book depreciation rate, since the depreciation period will be extended to as long as 35 years for shippers that pay extended-term rates."[110] The Commission approved the ET Settlement in July 2000.[111]

97. As is clear from this description, the required *quid pro quo* for an Original System shipper to obtain Period One rates more in line with Kern River's extended depreciable life was its agreement to extend the duration of its Period One contract. If an Original System shipper chose not to extend the original 15-year term of its contract, it would continue to have to pay its share of 70 percent of Kern River's invested capital over the term of that contract, despite the fact that

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[107] June 13, 2000 Offer of Settlement in Docket No. RP00-298-001 (ET Settlement).

[108] *Id.* at p. 2.

[109] *Id*. (emphasis supplied).

[110] *Id*. at p. 4.

[111] *ET Settlement Order*, 92 FERC ¶ 61,061, *order on reh'g*, 94 FERC ¶ 61,115.

term now constituted only about 43 percent of Kern River's revised 35-year depreciable life.[112] Moreover, whichever contract extension option an Original System shipper chose, its revised levelized rate would still be designed to recover the same 70 percent of Kern River's invested capital. The ET Settlement thus reconfirmed the inherent tie between the length of the Period One levelization period and the duration of shippers' Period One contracts. In addition, the ET Settlement was limited to modifying the shippers' Period One contracts and it contained no provision concerning Period Two.

98. BP nevertheless relies on Kern River's response to comments opposing the ET Settlement and a statement in the Commission's order approving the settlement to argue that the settlement contemplated that Period Two would be extended to match Kern River's extended depreciable life, with Kern River levelizing its recovery of its remaining invested capital over that entire period without any tie to the duration of the shippers' Period Two contracts. In the reply comments relied on by BP, Kern River was responding to a concern raised by Sempra Energy, which was not itself a Period One firm shipper on Kern River, that the ET Settlement could adversely affect the Period One shippers who did not extend their contracts ("Status Quo shippers") by subjecting them to increased Period Two rates. As BP points out, Kern River stated that "the 'step-down' period [*i.e.*, Period Two] which is used to collect the remaining 30 percent of the investment costs for Status Quo shippers would be extended to twenty years, instead of the currently approved ten-year period applicable to Kern River's current rates. This will have the effect of lowering the rates during the 'step-down' period for the Status Quo Shippers."[113] Similarly, the Commission's order approving the ET settlement found that Kern River adequately explained that its

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[112] The ET Settlement referred to shippers that chose not to participate in the ET program as "Status Quo shippers" and referred to their rates as the Status Quo rates. All of Kern River's firm shippers on the Original System chose to extend their contracts, so that once the ET Settlement was implemented there were no Status Quo Shippers.

[113] Kern River's ET Settlement Reply comments in Docket No. RP00-298-001 at p. 6. BP states that, at the time of Kern River's reply comments, a twenty-year Period Two would have corresponded to the anticipated remaining depreciable life of Kern River's system after 10-year extended term Period One contracts expired. BP also points out that Kern River made no mention in the ET Settlement proceeding that it would require 20-year contracts in connection with its agreement to extend Period Two to match the remaining depreciable life of the system.

proposal would not shift costs between the Status Quo, 10-year, and 15-year rate groups. The Commission stated:

> During the "step down" period, the rates are designed to recover the remaining investment (30 percent equity investment). Thus, the ‘step down" period rates will be lower since the extended depreciable life of Kern River will be used to compute lower ‘step down’ period rates. For example, a Status Quo shipper who renews its contract in 2007 will be eligible for a ‘step down’ period rate which includes depreciation computed over the period ending in 2032, instead of in 2017.[114]

99. The Commission does not discern in Kern River’s reply comments any commitment by Kern River to offer Period Two rates levelized over its entire remaining book depreciable life, without any corresponding contractual commitment by Period Two shippers to take service for all or most of that period. While Kern River’s reply comments raised the possibility that Period Two could be extended to match the extension of its depreciable life, those comments did not address the conditions under which such an extension would be permitted. Nor did Kern River make any commitment not to tie such an extension to the duration of shippers’ Period Two contracts. In fact, Kern River clearly stated later in its Reply Comments that Sempra was:

> raising issues concerning future rates that are not a part of this filing nor before the Commission at this time; *i.e.*, the “stepdown period” rates which will not be addressed until after the expiry of the contracts underlying the Status Quo rates and the ET rate options. Those future rates are not before the Commission at this time. They should be and will be addressed and evaluated in future Kern River proceedings.[115]

100. Given the facts that the ET Settlement itself is silent concerning Period Two and that Kern River stated its Period Two rates were not before the Commission and would have to be addressed in a future Commission proceeding, we do not find Kern River’s reply comment relied on by BP to be determinative of

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[114] *Kern River*, 92 FERC at 61,159.

[115] *Id*. P 7.

the issue now before us: the nature of the shipper contractual commitment necessary to obtain Period Two rates levelized over Kern River's entire remaining depreciable life. The ET Settlement expressly conditioned an extension of the Period One levelization period from 15 years to either 19 or 24 years on the shippers agreeing to a corresponding extension of their Period One contracts. Absent some more explicit statement by Kern River of an intent to treat Period Two differently from Period One, we do not interpret the settlement as requiring Kern River to extend the Period Two levelization period from 10 years to as much as 28 years, as now sought by BP and NVE, without any contractual commitment to take service during the whole levelization period comparable to that required for Period One.In addition, shorter Period Two contracts of 10 or 15 years, as sought by BP and NVE, would leave Kern River with a substantial unrecovered regulatory asset at the end of their contracts. This is in contrast to Kern River's expectation that the ET Settlement would lead to no unrecovered regulatory asset at the end of Period One.[116] The ET Settlement thus provided Kern River assurance of a reasonable return for service provided during Period One with no unrecovered regulatory asset at the end of that period. It would be inconsistent with these facts to interpret that settlement as requiring Kern River to provide Period Two service under contracts which would not provide Kern River a reasonable return on the actual outstanding capital the pipeline has invested in providing service during the terms of those contracts.

101. Similarly, the Commission's order approving the ET Settlement did not reach the issue of what duration contract a shipper would have to agree to in order to obtain Period Two rates levelized over Kern River's entire remaining depreciable life. Our focus in that order was analyzing whether the ET Settlement would cause unreasonable cost shifting among different customer groups, not determining issues such as how the duration of shipper contracts for service during Period Two should be coordinated with the length of the Period Two levelization period. Thus, we do not interpret that order as requiring that Kern River levelize the remaining 30 percent of its original invested capital over its entire remaining depreciable life without a contractual commitment from its shippers to take service beyond the initial period when the levelized rate is too low to provide Kern River a reasonable return on the capital devoted to providing service under the contract.

102. We recognize that both Kern River's reply comments and the Commission's orders approving the ET Settlement indicate an expectation that the extension of Kern River's book depreciable life would benefit shippers during Period Two. Our holdings in this proceeding are consistent with that expectation, because the extension of Kern River's depreciable life will benefit shippers who

[116] May 24, 2000 Kern River filing in Docket No. RP00-298-000 at 7.

renew their contracts, regardless of the duration of those contracts. As stated above, if BP and NVE had been willing to offer to enter into Period Two contracts extending until the October 31, 2039 end of Kern River's depreciable life, we would have required Kern River to offer them and other such shippers Period Two rates levelized over its entire remaining depreciable life. However, no shipper was willing to enter into such a contract. Nevertheless, even without the benefit of a rate reflecting the levelization of Kern River's recovery of the remaining 30 percent of its original invested capital over its entire remaining depreciable life, the extension of Kern River's depreciable life benefits its shippers over the remainder of that depreciable life following Period One.

103. Because of Kern River's longer book depreciable life, it will record less book depreciation expense in its accounts each year during the 10 or 15 year Period Two contracts we have approved than it otherwise would have. As explained above, Kern River is required to record any excess of its regulatory depreciation over its straight-line book depreciation as a regulatory liability.[117] The reduction in Kern River's book depreciation rate pursuant to the ET Settlement, and the further reduction in this proceeding, thus will lead to Kern River recording a significant regulatory liability on its books by the end of either 10 or 15-year Period Two contracts, which it would not otherwise have if its depreciable life had not been extended. The subtraction of that regulatory liability from the starting rate base used to design its Period Three rates, will reduce the Period Three rates by significantly offsetting the costs of any new investments Kern River has made in its system. This will make it more likely that at the end of the Period Two contracts the Period Three rates will be designed only to recover operating expenses, taxes, and a reasonable management fee as anticipated in the rate design principles approved in the optional expedited certificate proceeding.

104. Finally, BP again cites various statements in Opinion Nos. 486 through 486-D as representing Commission holdings that Period Two must extend for Kern River's entire depreciable life.[118] In Opinion No. 486-E, the Commission

[117] Section 7.3 of the ET Settlement provides that regulatory asset and liability accounting will apply to all differences between book and regulatory depreciation.

[118] BP Request for Rehearing at pp.4, 14-25 (citing, Opinion No. 486, 117 FERC ¶ 61,077, at P19, *See also* Opinion No. 486-C, 129 FERC ¶ 61,240 at P3, Opinion No. 486-B, 126 FERC ¶61,034, P2,168, n.275, 188 (2009), Opinion No. 486-A, 123 FERC ¶61,056, P2 (2008), Opinion No. 486, 117 FERC ¶ 61,077, at P 15, n.32, *ET Settlement Order*, 92 FERC 61,159, *reh'g denied*, 94 FERC ¶ 61,116).

addressed arguments regarding whether it had previously made determinations upon the length of Period Two or Period Two service contract in earlier orders in the Opinion No. 486 series. The Commission stated:

> 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." 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," 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." 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."[119]

[119] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 69 (internal citations omitted).

105. BP argues that Opinion No. 486-E misinterpreted Opinion No. 486-C. BP contends that Opinion No. 486-C recognized that Period Two must cover Kern River's entire remaining depreciable life and only set for hearing the issue of the length of the Period Two contracts and whether those contracts should run through the end of Kern River's depreciable life. However, BP ignores the fact that among the options Opinion No. 486-C set forth for resolving the issue of how to coordinate the length of the shippers' Period Two contracts with the length of the levelization period was:

> offering optional contract lengths that are shorter than Kern River's remaining depreciable life . . . 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*.[120]

That is the option adopted in Opinion No. 486-E and reaffirmed here.

106. BP also cites Opinion No. 486-D's statement that "when the extended Period One contracts expire on September 30, 2011 Kern River will still have a remaining depreciable life of over 30 years. Therefore, Period Two will be several times longer than the 10 years anticipated when the optional expedited certificate issued, because of the increase in Kern River's depreciable life."[121] BP further points out that Opinion No. 486-D reaffirmed Opinion No. 486-C's rejection of Kern River's contention that Commission policy requires that a levelized cost of service must be coterminous with the contracts under which a pipeline's shippers will take service at levelized rates.[122]

107. However, Opinion No. 486-D also stated that

> [W]hile the Commission reaffirms . . . that Commission policy *permits* rates to be levelized over a longer period than the terms of the shipper contracts, *neither Opinion No. 486-C nor this order make any final decision concerning whether, and how, the duration of shipper contracts for service during Period Two should be coordinated with the length of the*

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[120] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 260 (emphasis supplied).

[121] Opinion No. 486-D, 133 FERC ¶ 61,162 at P 166.

[122] *Id*. PP 171-172.

> *Period Two rate levelization period.* Opinion No. 486-C set that issue for hearing. Among other things, the Commission noted the fact Kern River's shippers' Period One contracts have always been coterminous with the length of the Period One contracts applicable to each shipper may suggest an underlying assumption, when its Original System was certificated that firm shippers would also be required to have contracts for the entire length of Period Two.[123]

Opinion No. 486-D then noted that Opinion No. 486-C had listed at least four possible options for resolving the issue of whether and how the duration of Period Two contracts should be coordinated with the length of the levelization period, "some of which would require the shipper's Period Two contracts to match the levelization period underlying the rate to be paid by that shipper,"[124] and the Commission permitted all parties at the hearing to present their positions on this issue. Thus, in neither Opinion No. 486-C nor Opinion No. 486-D, did the Commission hold that Period Two must extend for the full remainder of Kern River's depreciable life. Moreover, while the Commission held that its policy "permitted" rates to be levelized over a longer period than the terms of the shipper contracts, the Commission did not reach the issue of whether it would be reasonable to require a pipeline to offer levelized rates without such a contractual commitment.

108. The Commission finds that BP has not advanced any argument that would compel the Commission to reconsider this observation and the Commission rejects the contention that this observation carries any undue weight as a part of the Commission's findings on this matter. Accordingly, the Commission rejects BP's arguments on this issue.

C. <u>Procedures for Establishing Period Three Rates</u>

109. As discussed in the preceding section, Opinion No. 486-E held that, at the end of their Period Two contracts, Kern River must offer its levelized rate shippers service at stepped-down Period Three rates, reflecting removal from Kern River's rate base of all its original invested capital.[125] Therefore, the Commission required that Kern River include in its tariff a provision that, on or before two

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[123] *Id*. P 173 (emphasis added).

[124] *Id*.

[125] Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 73-74.

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.

110. The Commission acknowledged that in its previous orders in this proceeding it found that it was not necessary for Kern River to include the future Period Three rates in its tariff. The Commission stated that it continues to believe that it would be premature now to attempt to calculate such rates which will not take effect for at least ten years. However, the Commission reasoned that:

> given the outcome of the hearing and the facts before it, the Commission now finds that 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. 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. Accordingly, for the same reasons the Commission held that it would be 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.[126]

111. The Commission concluded that the required *pro forma* tariff filing two years before the expiration of the first set of Period Two contracts would give the Commission sufficient time 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 consider any appropriate management fee for the rates in lieu of return on rate base.

<u>Request for Rehearing</u>

112. Kern River seeks rehearing of this aspect of Opinion No. 486-E and contends that the *pro forma* tariff filing obligation placed on Kern River is unreasonable and unlawful. Kern River first argues that the Commission has no

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[126] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 73. (footnotes omitted).

authority to impose such a tariff obligation on Kern River. Kern River maintains that the Commission cites no authority, nor any support in the record, for taking this extraordinary action. Kern River states that the Commission relies on its prior rulings relating to Period One and Period Two rates in this case where the Commission, acting under its NGA section 5 authority, previously concluded that Period One rates were unjust and unreasonable unless Kern River's tariff also included Period Two rates for shippers that may elect to continue taking service beyond the terms of their existing contracts.

113. Kern River now asserts that the Commission, once again relying on its NGA section 5 authority, contends that the same rationale now applies here to the filing of *pro forma* Period Three rates. However, Kern River argues that the Commission in this instance has overreached and has required Kern River to put this future rate filing obligation in its tariff now without any justification for why such action is a valid remedy under its NGA section 5 authority.

114. Kern River argues that the right of Period Two shippers to receive Period Three rates at the end of their Period Two contracts is well-documented and that it has never disputed the entitlement of Period Two shippers to elect to continue service at the end of Period Two. But Kern River maintains that there is no basis for attempting to determine far in advance what the Period Three rates should be and therefore, even assuming that the Commission has the authority to compel Kern River to state a rate filing obligation in its tariff, the Commission has not presented any valid basis for doing so.

115. Kern River argues that the Commission offers no rationale for usurping Kern River's right to file Period Three rates under NGA section 4. Kern River asserts that under the Commission's regulations, Kern River cannot file rates more than two months in advance of their proposed effectiveness.[127] Therefore, it asserts that the requirement that it file *pro forma* tariff sheets proposing Period Three rates for all shipper groups two years before the expiration of the first set of Period Two contracts will require Kern River to propose Period Three rates well before the regulations would even allow Kern River to file rates under NGA section 4. Kern River argues that because the filing obligation is inconsistent with the NGA, the requirement to state that obligation in Kern River's tariff is also unlawful.

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[127] Kern River Request for Rehearing at p. 55 (citing, 18 C.F.R. § 154.207 (2012) (requiring tariffs be filed not less than 30 days nor more than 60 days prior to the proposed effective date)).

116. Kern River further contends that the Commission has previously in this proceeding declined shippers' requests to include future Period Three rates in Kern River's tariff because forecasting Period Three rates to be effective several years in the future requires too much speculation. Kern River argues that the Commission has now arbitrarily determined such speculation is warranted. Moreover, Kern River argues that to the extent the Commission intends Kern River to base the *pro forma* Period Three rates for all shipper groups based on projected costs as of the time of the filing required by Opinion No. 486-E, the exercise will be of little or no benefit to Period Two shippers because the Period Three contracts of most shipper groups will not even begin until many years (for some, as many as 14 years[128]) after Kern River's *pro forma* filing, thereby making any such calculations speculative, at best. Kern River argues that requiring it to file Period Three rates more than two years prior to the start of Period Three for some shipper groups would involve the same level of speculation that the Commission has consistently found to be unreasonable when it addressed Period Three rates in prior orders. Therefore, it argues that the Commission's *pro forma* filing requirement should be reversed.

117. Finally, Kern River argues that if the Commission declines to rescind its determination that Kern River must file its Period Three rates, as directed by Opinion No. 486-E, Kern River asserts that the Commission must clarify its description of the Period Three rates Kern River must submit.

Commission Determination

118. The Commission generally denies rehearing on this issue. However, the Commission will grant rehearing of the requirement that Kern River submit *pro forma* Period Three rates for *all* shipper groups two years before the end of Period Two for the first set of expiring Period Two contracts. Instead, the Commission will require Kern River to submit *pro forma* Period Three rates for each shipper group two years before the Period Two contracts of that shipper group expire. In addition, this requirement will only be applicable if Kern River's tariff does not already include Period Three rates for the shipper group in question, as a result of a prior NGA section 4 filing by Kern River or other action by the Commission.

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[128] Kern River explains that if shippers in the initial group to reach Period Two (the 10-year extended term Original System shippers) decide to contract for 10 years, Kern River would have to make its Period Three *pro forma* filing in 2019, two years before the September 30, 2021 expiration of those contracts. However, if shippers in the last group to reach Period Two, the 15-year 2003 Expansion shippers, elect to re-contract for 15 years, they would not reach Period Three until 2033, 14 years after Kern River's filing.

119. As Kern River recognizes, the Commission acted pursuant to NGA section 5, when it required Kern River to place in its tariff a provision requiring it to submit *pro forma* 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 rejects Kern River's contention that it lacks authority under NGA section 5 to require Kern River to include such a future rate filing obligation in its tariff.

120. In Opinion No. 486-E, the Commission held that it would 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 "*for the same reasons* the Commission held that it would be unjust and unreasonable for Kern River to fail to offer Period One shippers stepped-down Period Two rates at the end of Period One."[129] In Opinion No. 486-A, the Commission, in imposing the obligation to place Period Two rates into Kern River's tariff addressed arguments similar to those raised here by Kern River. There, the Commission reasoned:

> The Commission determined that Kern River's proposal did not provide adequate assurances that its shippers would obtain the benefit of the lower Period Two rates if they continued service beyond the terms of their existing contracts. Because the Commission viewed the opportunity for shippers to obtain the lower Period Two rates upon the expiration of their existing contracts as a vital component of the levelization methodology proposed by Kern River, and because the Commission concluded that the makeup of the Period Two rates would be more transparent, the Commission concluded that the implementation of the Period One rates without the benefit of the stepdown Period Two rates included in Kern River's tariff was unjust and unreasonable. Therefore, the Commission directed that Kern River file revised tariff sheets setting forth its currently proposed rates based upon the instant cost of service as well as the rates and effective date of the step-down Period Two rates to be available to its 10 and 15 year shippers. Nothing raised by Kern River on rehearing compels the Commission to find that such action was beyond its authority.[130]

[129] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 73 (emphasis added).

[130] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 62.

121. As the Commission found in Opinion No. 486-E, the same reasoning applies with respect to the requirement for Kern River to include Period Three rates in its tariff before the expiration of its Period Two rates. The Commission has approved Kern River's proposal to recover the entire remaining 30 percent of its original invested capital during the 10 or 15-year terms of the shippers' Period Two contracts. However, we can only find that proposal just and reasonable to the extent that Kern River offers its shippers rates reflecting the removal of that invested capital from its rate base immediately upon the expiration of the Period Two contracts. Any continuation of the rates we have approved for Period Two into Period Three would be unjust and unreasonable, because those Period Two rates include both a return of and a return on invested capital which Kern River should have fully recovered by the end of Period Two.

122. Even so, Kern River argues that the Commission has offered no rationale for attempting to determine Period Three rates so far in advance of their effective date. In Opinion No. 486-E, the Commission acknowledged that in its previous orders in this proceeding it found that it was not necessary for Kern River to include the future Period Three rates in its tariff at this time,[131] and we continue to believe that it is premature to calculate Period Three rates at this time, nearly 15 years before any Period Two contract could expire.[132] However, in order to have just and reasonable Period Three rates in effect before the date Period Two contracts expire, it is necessary to commence the proceeding to establish the Period Three rates sufficiently before that date to provide time for the Commission to complete its determination of just and reasonable Period Three rates before Period Three begins. Absent a section 4 filing by Kern River proposing Period Three rates, the Commission will have to implement such rates pursuant to NGA section 5. We can only implement revised rates under section 5 on a prospective basis. As our experience in determining just and reasonable Period Two rates pursuant to NGA section 5 demonstrates, fixing just and reasonable rates in a

[131] *See, e.g.* Opinion No. 486-B, 126 FERC ¶ 61,034 at PP 190-191.

[132] The two Original System shippers with 10-year contracts expiring on September 30, 2011 elected not to take service during Period Two. The only 2002 Expansion Shipper with a 10-year contract expiring on April 30, 2012, elected a 15-year Period Two contract, which will expire April 30, 2027. Of the 2003 Expansion shippers with 10-year contracts expiring on April 30, 2013, only one elected to take Period Two service, and that shipper elected a 15-year contract expiring on April 30, 2028. The contracts of the 15-year shippers on the Original System and the 2002 and 2003 Expansions, which account for approximately 90 percent of Kern River's overall capacity on the Original System and those two expansions, will not start expiring until September 30, 2016.

section 5 proceeding can be a time consuming process. We believe that two years is a reasonable estimate of the amount of time required to fix just and reasonable Period Three rates pursuant to NGA section 5.

123. Therefore, we will continue to require Kern River to submit *pro forma* Period Three rates for the first shipper group whose Period Two contracts expire on or before two years before the Period Two contracts of that shipper group expire. However, we recognize that it may be a number of additional years before the Period Two contracts of some other shipper groups expire. Therefore, Kern River need not include *pro forma* Period Three rates for all shipper groups in its first *pro forma* Period Three filing. Instead, we modify the *pro forma* filing obligation to require Kern River to submit *pro forma* Period Three rates for each shipper group two years before the Period Two contracts of that shipper group expire.

124. Kern River asserts that Opinion No. 486-E improperly deprived it of its rights to file Period Three rates pursuant to NGA section 4. It also points out that under the Commission's regulations, Kern River cannot file rates more than two months in advance of their proposed effectiveness.[133] Therefore, it asserts that the imposed filing requirement will require Kern River to propose Period Three rates, on a *pro forma* basis well before the regulations would even allow Kern River to file rates under NGA section 4. Kern River argues that because the filing obligation is inconsistent with the NGA, the requirement to state that obligation in Kern River's tariff is also unlawful.

125. The Commission can find no basis for Kern River's argument that the Commission has usurped Kern River's NGA section 4 rights by requiring Kern River to file *pro forma* tariff sheets two years before its implementation of Period Three rates. Kern River has cited court precedent which on one hand prohibits the Commission from requiring a pipeline to initiate a NGA section 4 proceeding and on the other from depriving a pipeline from its right to make such a filing.[134] In the instant case, the Commission has not taken action which would run contrary to

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[133] Kern River Request for Rehearing at p. 55 (citing, 18 C.F.R. § 154.207 (requiring tariffs be filed not less than 30 days nor more than 60 days prior to the proposed effective date)).

[134] *Id*., (citing, *Pub. Serv. Comm. of N.Y. v. FERC*, 866 F.2d at 488 (Commission cannot require interstate pipelines subject to NGA jurisdiction to initiate a new rate filing); *Atl. City Elec. Co. v. FERC*, 295 F.3d 1, 10 (D.C. Cir. 2002) (Commission cannot deprive a jurisdictional company of the right to initiate rate changes)).

either of these prohibited actions. Because the Commission lacks authority to require Kern River to make a NGA section 4 filing proposing Period Three rates, the Commission did not do so, but instead has exercised its section 5 authority to require the *pro forma* filing.

126. The Commission also rejects the argument that the Commission's actions are contrary to our regulation prohibiting a pipeline from proposing a voluntary NGA section 4 rate case more than 60 days before it intends that the newly proposed rates take effect, absent a waiver of that regulation. That regulation only applies to section 4 filings, not to section 5 actions of the Commission. However, if Kern River desires to propose Period Three rates pursuant to NGA section 4 more than two months before the expiration of Period Two for any shipper group, the Commission would be willing to grant waiver of this regulation in the interest of facilitating the inclusion of Period Three rates in Kern River's tariff. If Kern River has made such a section 4 filing more than two years before the commencement of Period Three for any shipper group, the Commission will treat that filing as fulfilling the *pro forma* filing requirement imposed in this order with respect to that shipper group.

127. Kern River argues that if the Commission declines to rescind its determination that Kern River must file its Period Three rates, the Commission must clarify its description of the Period Three rates Kern River must submit. Kern River points out that Opinion No. 486-E states that Kern River's rate base used to develop its Period Three rates should reflect the removal of all original invested capital (including return on equity and associated income taxes).[135] Kern River does not contest this statement but it asserts that in Opinion No. 486-A, the Commission recognized that Kern River's recovery of depreciation expenses is not limited to its original capital investment.[136] Kern River argues that some of its depreciation expense relates to subsequent additions and replacements of general plant, compressor engines, and other assets, and some of these items are not, and will not be, fully depreciated before the end of Period Two. Accordingly, Kern River requests that the Commission clarify that any undepreciated rate base that Kern River retains at the end of Period Two related to additions to and replacements of original assets may be properly included in Period Three rates.

128. As set forth by Kern River, in Opinion No. 486-E, the Commission required that at the end of the current shipper contracts, the Period Two shippers

[135] Kern River Request for Rehearing at p.57 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 60, 64, 66).

[136] *Id.*, (citing, Opinion No. 486-A, 123 FERC ¶ 61,056 at P 42).

must be offered service at stepped-down Period Three rates, and these rates would "reflect[] removal from Kern River's rate base of all its *original invested* capital.[137] The Commission's statements clearly contemplate that the only depreciation or costs to be excluded from the Period Three rates is that related to the original investment in this system. Any subsequent investment in facilities, such as compressors, that are unrecovered at the end of Period Two may be reflected in the rate base used to calculate Period Three rates. However, as clarified above, any regulatory liability arising from the accelerated recovery of depreciation related to Kern River's original investment in its facilities must be subtracted from the starting Period Three rate base.

129. Kern River also requests that the Commission clarify Opinion No. 486-E's statements 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,"[138] and that "any escalation of [Period Two shippers'] rates to some higher level would be inconsistent with the rate design principles underlying the orders in the original certificate proceeding."[139] Kern River seeks clarification that these statements do not constitute an irrebuttable presumption that the Period Three Rates must be lower than Period Two rates. Whether the Period Three rates are ultimately lower or higher than the Period Two rates is a question that may only be answered when the Period Three rates are developed following the *pro forma* filing required by this order or in a section 4 rate filing by Kern River. However, as indicated in Opinion No. 486-E, the Period Three rates should be consistent with the Commission's orders in this proceeding and the original bargain on this system, including the requirements that all original invested capital and any related regulatory liability be removed from rate base.

130. Within 30 days of the date of this order, Kern River may revise its tariff provision concerning the filing of *pro forma* Period Three rates consistent with the above discussion.

D. Recovery of Compressor Costs in Period Two Rates

131. The issues presented here have their genesis in Kern River's initial NGA section 4 general rate case filing in this proceeding. In that filing Kern River proposed to remove the depreciation expenses for its Solar Mars compressors from

[137] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 60 (emphasis added). *See also* Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 61, 64.

[138] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 73.

[139] *Id.*

its levelized rate methodology. The depreciation charges related to the compressors would be recovered under a separate rate based on a revised straight line depreciation methodology of 12.53 percent. Opinion No. 486 rejected Kern River's proposal in two regards. First, it required Kern River to continue to include the compressor costs in its levelized rate methodology.[140] After an extensive analysis of the record, Opinion No. 486 also required Kern River to adopt a 9.92 percent depreciation rate for the compressors at issue and again stated that the revised depreciation rate must be included in Kern River's levelized rate methodology.[141] These determinations were affirmed by Opinion No. 486-A,[142] which also clarified that deferred depreciation of the compressor costs could be treated as a regulatory asset.[143] There was no discussion of these matters in the subsequent orders regarding Kern River's various compliance filings and the parties' rehearing requests through the end of 2009.

132. On January 29, 2010, Kern River made a revised compliance filing to Opinion No. 486-C[144] concerning its Period One rates. The Commission accepted that filing on November 18, 2010 in Opinion No. 486-D.[145] Kern River also made a separate February 1, 2010 compliance filing setting forth the Period Two rates required by Opinion No. 486-C.[146] Both filings included the compressor costs as a regulatory asset in Kern River's rate base. Thus, the balance of that regulatory asset at the end of Period One was also included in the rate base used to determine the return and income taxes to include in Kern River's Period Two rates. As discussed in Opinion Nos. 486-C and 486-D, Kern River must use a levelized rate methodology for both Period One and Period Two.[147] Under that methodology Kern River will over-recover some costs and under-recover others in Period One. Thus, as is explicitly stated in Opinion No. 486-A, if the costs of the Solar Mars compressors are over-recovered in Period One, the result is a regulatory liability.

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[140] Opinion No. 486, 117 FERC ¶ 61,077 at PP 55-57.

[141] *Id.* PP 464-476.

[142] Opinion No. 486-A, 123 FERC ¶ 61,056, at PP 366-369, 376-378.

[143] *Id.* PP 369-375.

[144] Opinion No. 486-C, 129 FERC ¶ 61,240.

[145] Opinion No. 486-D, 133 FERC ¶ 61,162 Ordering Paragraph (B).

[146] Opinion No. 486-C, 129 FERC ¶ 61,240 at PP 263-264.

[147] *Id.* P 245; Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 4, 12, 112-115, 171-173.

If those costs are under-recovered, the result is a regulatory asset.[148] The significance of this is that the regulatory liabilities are subtracted from the rate base used to calculate the return included in Kern River's Period Two rates. Thus, regulatory liabilities serve to reduce Kern River's Period Two rates, while regulatory assets increase Kern River's Period Two rates as it has under-recovered its costs in Period One.

133. Kern River's Period Two compliance filing proposed to continue to levelize its recovery of its investment in compressors and further description and general plant (compressor engines (CE)/ general plant (GP)), using the depreciation rates approved by the Commission. In that filing, Kern River started with its actual unrecovered invested capital in CE/GP as of the close of the 2004 test period being used in this rate case. Kern River then projected the costs it would incur to replace the compressors and general plant after the close of the test year 2004 (CE/GP replacement costs). At the hearing addressing Kern River's Period Two rates, the Shipper Parties and Staff opposed the inclusion of CE/GP replacement costs in Kern River's rate base and the inclusion of those costs in Kern River's levelized rate methodology during Period Two.[149]

134. 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.[150] The ID, therefore, held that inclusion of CE/GP replacement costs in Period Two rates was 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.[151] Opinion No. 486-E affirmed the ID.[152]

135. Both the ID and Opinion No. 486-E relied on the Commission's December 6, 2010 order in this proceeding and two related proceedings.[153] The Clarification Order addressed three filings that raised the issue of whether Kern River may

[148] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 368.

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

[150] *Id*. PP 1112-1158.

[151] *Id.* P 1112.

[152] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 131.

[153] Clarification Order, 133 FERC ¶ 61,199.

recover, in Period Two, the regulatory asset for its Solar Mars compressors reflected in its Period One and Period Two compliance filings.[154] The first filing was a motion for clarification in Docket No. RP04-274-023 seeking a Commission ruling that the compressorbased regulatory asset may be recovered through Kern River's Period Two rates.[155] The second filing was a proposed periodic surcharge in Docket No. RP10-1406-000 that would recover the entire compressor-based regulatory asset during the remainder of the Period One contracts.[156] The third filing was a conditional revised Period One compliance filing in Docket No. RP11-1499-000 that would revise Kern River's Period One rolled-in rates to assure the minimum necessary recovery of the compressor costs during Period One.[157] While the three filings were different in form, they all advanced the same assertions: i.e., that Kern River had a $37 million regulatory asset for compressors at the beginning of Period Two and that it must have a reasonable opportunity to recover this regulatory asset under its levelized rate methodology.[158]

136. The Commission granted the motion for clarification and held the following:

> Kern River may keep track of the difference between the annual allowance for deprecation of its compressors included in its levelized rates and the straight-line depreciation of those compressors recorded in its books. If at the start of Period Two, the cumulative allowance for depreciation of compressor 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.[159]

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[154] Clarification Order, 133 FERC ¶ 61,199 at P 4.

[155] *Id.* P 6.

[156] *Id.*

[157] *Id.* P 6.

[158] *Id.*

[159] *Id*. P 12.

137. The Commission did not address the amount of the regulatory asset in the Clarification Order. The Commission emphasized that while it was not addressing the particulars of this issue in the Clarification Order, "Kern River may not include in its regulatory assets new compressor costs that it has incurred after the 2004 test period."[160] The Commission further explained that to the extent Kern River desires to include such new costs, not incurred as of year-end 2004, in either its Period One or Period Two rates, it may do so through a new general section 4 rate case covering all of its cost of service factors, including the revenues obtained in a new test period.[161]

138. The Commission's determination in Opinion No. 486-E is consistent with the Clarification Order. Opinion No. 486-E found that Kern River sought to include new costs for replacement compressor units, i.e., costs incurred for compressor replacements after the 2004 test period, as part of the regulatory asset it would carry over into its Period Two rates.[162] The Commission held that Kern River may not include the CE/GP replacement costs it was projected to incur beyond the 2004 test period, finding that while this result would reduce the regulatory asset which Kern River sought to add to its rate base at the beginning of Period Two, it is a function of the levelized rate methodology initially agreed to by Kern River and its shippers.[163]

<u>Request for Rehearing</u>

139. In its request for rehearing of Opinion No. 486-E, Kern River objects to two aspects of the Commission's compressor cost ruling related to (1) the Commission's application of its test period regulations in the context of Kern River's levelized rates; and (2) the Commission's assertion that Kern River's proposal is a departure from "its original bargain with its shippers" regarding the levelization methodology.[164]

140. Kern River claims that the Commission failed to justify its application of the test-period concept in the atypical circumstances of this case.[165] Kern River

[160] *Id*. P 14.

[161] *Id*.

[162] Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 138-140.

[163] *Id*., P 142.

[164] Kern River Rehearing Request at 25-26.

[165] *Id*. at 26.

states that the principal purpose in establishing Period Two rates in this proceeding is to assure shippers that the step-down rates will reflect the net regulatory liability that is expected to accrue by the end of Period One under Kern River's book and regulatory depreciation schedules.[166] Kern River also quotes passages from Opinion No. 486-D, stating that the starting point for calculating Period Two rates must be the cost of service for Period One based on 2004 test year data.[167]

> The only exception to this general approach to developing Kern River's Period Two rates is where there are circumstances unique to the transition from Period One to Period Two rates that justify an adjustment to the cost of service underlying the Period One rates. These circumstances include, of course, the fact the Period Two rates must return the excess recovery of depreciation expenses existing at the end of Period One. Accordingly, the parties at the hearing may address all issues related to whether the Period Two rates have been appropriately adjusted to return the excess recovery of depreciation projected to occur during Period One based upon the 2004 test period data used to develop Kern River's rates in this rate case.[168]

141. Kern River asserts that the Clarification Order expressly affirms that differences between book depreciation recorded and regulatory depreciation recovered related to CE/GP replacements that are not recovered in Period One may be recovered in Period Two.[169] Kern River states that the regulatory asset adjustments it made in calculating its Period Two rates reflect the book depreciation rates established in Opinion Nos. 486 and 486-A, and are based on the replacements intervals, asset costs, and salvage value established in the record for all replacements from Kern River's inception of service through the end of the 2004 test period.[170]

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[166] *Id.* (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 54; Opinion 486-C, 129 FERC ¶ 61,240 at PP 226, 247).

[167] *Id.* at 27 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 193).

[168] *Id.* (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at P 194).

[169] *Id*. (citing Clarification Order, 133 FERC ¶ 61,199 at PP 12-13).

[170] *Id*. at 28-29.

142. Kern River contends that its proposal is the type of transitional matter that Opinion Nos. 486-C and 486-D authorized including in Period Two rates. Kern River argues that despite Commission statements that adjustments that reflect the transition from Period One to Period Two are permissible, and despite Kern River's repeated contentions that its regulatory asset/liability adjustments for CE/GP replacements are directly related to that transition, Opinion No. 486-E does not address the transitional character of Kern River's proposal.[171]

143. Kern River next contends that from the outset, this case has presented circumstances related to depreciation of CE/GP that are different from prior proceedings.[172] Kern River notes that when it filed its proposed rate change in this proceeding in 2004, its turbine fleet had grown from 4 compressors at 3 mainline stations to 20 compressors at 9 mainline stations.[173] Kern River further states that the Commission's expansion of this case to include Period Two rates to become effective anywhere from 7 to 14 years after the test period amplified the cost-of-service significance of those changes.[174] Kern River also states that the Commission's decision to establish higher book depreciation rates for CE/GP while requiring that those costs remain in the levelization calculations further compounds the amounts of deferred depreciation that must be addressed when establishing rates in future periods.[175] Kern River contends that the Commission disregarded these circumstances in its evaluation of Kern River's Period Two rates, rendering its decision arbitrary and capricious.[176]

144. Kern River argues that it is not enough for the Commission to simply state that Kern River can file a rate case if it is unsatisfied with the Commission's decision.[177] Kern River also asserts that the Commission's observation that the proposed adjustment for deferred depreciation related to replacements of CE/GP after the end of the test period was not part of Kern River's original levelization methodology does not justify its refusal to consider the merits of Kern River's

[171] *Id*. at 29.

[172] Kern River Rehearing Request at 29-30.

[173] Kern River Rehearing Request at 30.

[174] *Id*.

[175] *Id*.

[176] *Id*.

[177] *Id*.

proposal. Kern River contends that its proposal to modify its levelization methodology to address the effect of CE/GP replacements on Period Two rates fits squarely within the scope of the inquiry the Commission set for hearing in this section 5 remedy phase of the proceeding. Moreover, Kern River claims that Opinion No. 486-E failed to show that the rates it established were fair because it disregarded these substantial, known, and measureable deferred depreciation for CE/GP replacements that occurred prior to Period Two rates taking effect.[178]

145. Kern River states that the Commission may not rely on "rate design principles" established in Kern River's initial section 7 proceeding because the rates established in that proceeding have been superseded.[179] Kern River also states that the Commission's reference to defining the rate base as of the end of the test period does not explain why the adjustments Kern River proposed do not fit the exception for transitional matters.[180] Kern River claims that while differences between book and regulatory depreciation for non-CE/GP plant that accrue between the end of the test period and the start of Period Two will be reflected in the beginning Period Two rate base, all such differences for CE/GP replacements are excluded from Period Two rate calculations.[181]

146. Kern River states that Opinion No. 486-E does not give a rational basis for this outcome and is directly contrary to the assurance in Opinion No. 486-A that CE/GP will be treated the same as all other plant.[182] Kern River further asserts that the Commission's approach will cause Kern River's Period Two rates to credit shippers with a greater regulatory liability than is warranted, which will undermine one of the Period Two hearing's primary goals, *i.e.*, to properly adjust Kern River's rates to reflect the net regulatory liability that will have accrued at the end of Period One.[183]

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[178] Kern River Rehearing Request at 32.

[179] Kern River Rehearing Request at 31-32 (citing *Tenn. Gas Pipeline Co. v. FERC*, 860 F.2d 446, 449 (D.C. Cir. 1988); *KO Transmission Co.*, 74 FERC ¶ 61,101, at 61,310 (1996); *Algonquin Gas Transmission Co.*, 65 FERC ¶ 61,139, at 61,705 (1993)).

[180] Kern River Rehearing Request at 32.

[181] Kern River Rehearing Request at 32-33.

[182] Kern River Rehearing Request at 33 (citing Opinion No. 486-A, 123 FERC ¶ 61,056 at P 371).

[183] *Id.*

147. Kern River argues that the Commission erred in asserting that the rate base must be a “snap shot” for the purposes of calculating Kern River’s levelized rates.[184] Kern River states the Commission has recognized that Kern River’s levelization models extrapolate and average rate base balances over the entire levelization period in order to derive the levelized annual costs of service.[185] Kern River states that while replacements of long-lived assets are not typically reflected in these calculations, that is not the case for CE/GP replacements at issue here.

> Kern River also objects to the Commission’s determination that Kern River’s proposal here marks a departure from its original bargain with its shippers regarding the levelization methodology.[186] Kern River states that this rationale is unfounded because Kern River has no agreements providing for levelized rates in Period Two with its shippers.[187]Kern River also requested clarification, or in the alternative, rehearing of the Clarification Order. Kern River asserts that the Clarification Order states that: 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 include such new costs . . . it may do so. 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. 133 FERC ¶ 61,199 at P 14 (2010) (emphasis added)
> .

148. Kern River asserts that under levelization, deferred depreciation associated with all depreciable plant, and attributable to any and all differences between book and regulatory depreciation, is reflected in rates and that the deferred depreciation that is included in Period Two rates must reflect the Commission approved book depreciation expense for the 2004 test period, and the gross plant balances underlying the 2004 test period cost of service.

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[184] *Id.* (citing Opinion No. 486-E, 136 FERC ¶ 61,045 at P 145).

[185] *Id.* (citing Opinion No. 486-A, 123 FERC ¶ 61,056 at PP 110, 115).

[186] Kern River Rehearing Request at 34 (citing Opinion No. 486-E, 136 FERC ¶ 61,045 at P 146).

[187] Kern River Rehearing Request at 34 (citing Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 120, 177).

149. Kern River argues that in Opinion Nos. 486, *et seq*., the Commission ordered the continued levelization of depreciation of CE/GP plant, but approved new, higher, book depreciation rates for CE/GP assets. Kern River states that as a result, the deferred depreciation associated with CE/GP replacements that is recorded as a regulatory asset increased. Kern River asserts while the Clarification Order granted its request regarding the recovery of such regulatory asset amounts in Period Two rates in this proceeding, certain Intervenors nevertheless claim that the language quoted above actually eliminates Kern River's right to include the regulatory asset associated with deferred depreciation for Period One CE/GP replacements in the starting rate base balance for Period Two.

150. Kern River argues that because the deferred depreciation associated with CE/GP replacements (at the intervals and costs underlying the approved book depreciation rates) must be projected in order to derive the correct Period Two starting rate base, the deferred depreciation regulatory asset for CE/GP included in the Period Two rates merely reflects the recovery of Commission-approved depreciation expense for the test period CE/GP plant balances.

151. Accordingly, Kern River requests that the Commission clarify that the Clarification order correctly established that:

> for purposes of the calculation of Period Two rates in this proceeding, (i) in accounting for deferred depreciation associated with CE/GP replacements during the remainder of Period One, and thus, (ii) in determining Kern River's regulatory asset/liability balance at the end of Period One (to be recovered in Period Two), Kern River is required and permitted to use 2004 test period costs, including the CE/GP plant balances and net replacement costs underlying the 2004 test period cost of service, and the approved, CE/GP book depreciation rates. Kern River Motion for Expedited Clarification at pp.5-6.

152. Further, Kern River states that the Commission should clarify that its reference to "new compressor costs incurred after the 2004 test period" is understood to refer to any costs of CE/GP replacements incurred by Kern River after October 31, 2004, that exceed the underlying 2004 test period replacement costs, as well as any incremental investment in CE/GP assets that would increase gross plant relative to the test period plant balance. Therefore, Kern River states that deferred depreciation for CE/GP replacements that accrues after the test period does not constitute "new costs," so long as the amounts deferred are based on (i) the approved book depreciation rates for CE/GP plant, and (ii) the CE/GP

replacement costs for the 2004 test period on which those book depreciation rates are based.

153. Kern River asserts that deferred depreciation that conforms with these criteria is properly reflected in the beginning Period Two rate base for this proceeding. Kern River emphasizes that it is not seeking to reflect in rates any incremental CE/GP costs above the 2004 test period replacement costs but rather seeks only to recover in Period Two the portion of its existing, approved book depreciation expense for CE/GP that is deferred by operation of the levelization methodology.

154. Kern River argues that its interpretation is compelled by the levelized rate structure, emphasizing that it seeks only to recover in Period Two rates the portion of its existing, approved book depreciation expense for CE/GP that is deferred (as a regulatory asset) by operation of its levelization methodology.

Commission Determination

155. For the reasons discussed below, we affirm Opinion No. 486-E and deny Kern River's request for rehearing on this issue. In Opinion No. 486-E, the Commission affirmed the ALJ's determination that Kern River improperly included the costs it projected it would incur after the end of the 2004 test period to replace compressors (CE/GP replacement costs) in its Period Two rates.[188] Kern River objects to this holding, arguing that its Period Two rates—at least with respect to CE/GP costs—should not be bound by the test period and should instead reflect CE/GP replacement costs that were incurred after the test period established in this case. Thus, the issue here is whether Kern River is entitled to adjust its Period Two rate base to include post-test-period CE/GP replacement costs.

156. We find that Kern River may not do so, and therefore we deny rehearing on this point. Kern River advances a number of arguments as to why it should be entitled to recover CE/GP replacement costs that were incurred after the test period applicable to this case. However, none of these arguments are persuasive. As explained below, there is nothing about the post-test-period CE/GP replacement costs that is unique to the transition from Period One to Period Two rates that would justify an adjustment to the Period Two rate base. Nor does the fact that Kern River extrapolated the CE/GP replacement costs from elements of its 2004 cost-of-service justify their inclusion here. It is important to emphasize that Kern River is not without a remedy here. To the extent Kern River believes its 2004 cost-of-service to be stale, and in need of updating, it is free to propose

[188] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 131.

new rates under section 4 of the NGA. However, Kern River may not selectively update certain elements of its 2004 cost-of-service to include increased costs in its Period Two rates (e.g., CE/GP replacement costs) while disregarding significant increased revenues, such as those resulting from its 2010 Expansion.

157. Before addressing Kern River's specific arguments, it is important to put this issue in context. In Opinion No. 486-D, the Commission explained 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."[189] The Commission explained that it generally does not permit limited section 4 or 5 rate cases that would revise certain rates without taking the pipeline's entire cost of service into consideration.[190] The Commission further explained that allowing such a limited rate change here would have an unduly discriminatory result, i.e., different Period Two rates for identical services on identical facilities based only on the starting date of shippers' Period Two contracts.[191] Notwithstanding, the Commission explained that the requirement for Period Two rates to be based on the original 2004 cost of service is not without exception.

> The only exception to this general approach to developing Kern River's Period Two rates is where there are circumstances unique to the transition from Period One to Period Two rates that justify an adjustment to the cost of service underlying the Period One rates. These circumstances include, of course, the fact the Period Two rates must return the excess recovery of depreciation expenses existing at the end of Period One.[192]

The Commission listed other specific issues that were subject to change in Period Two.[193] Nowhere, however, did the Commission indicate that post-test-period

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

[190] *Id.*

[191] *Id.*

[192] *Id.* P 194.

[193] *Id.* PP 195-200 (listing such issues as the use of a 100 percent equity structure for the Period Two rates, Kern River's return on equity (in light of the change in capital structure), the appropriate billing determinants upon which to design Period Two rates, the extent to which the duration of shipper contracts for

CE/GP replacement costs were either "unique to the transition" from Period One to Period Two rates or otherwise subject to adjustment of the Period Two rate base.

158. Subsequent to Opinion No. 486-D, the Commission issued the Clarification Order, which specifically addressed the treatment of CE/GP replacement costs. The Commission first explained the manner in which Kern River can recover its deferred depreciation related to compressors in Period Two.

> Kern River may keep track of the difference between the annual allowance for depreciation of its compressors included in its levelized rates and the straight-line depreciation of those compressors recorded in its books. If 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.[194]

This excerpt from the Clarification Order is consistent with the above-quoted section of Opinion No. 486-D, which found that "Period Two rates must return the excess recovery of depreciation expenses existing at the end of Period One." The Commission then addressed precisely the issue raised here, i.e., the manner in which post-test-period compressor costs many be recovered.

> [W]hile 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 include such new costs, not incurred as of year-end 2004, in either its Period One or Period Two rates, it may do so. 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

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service during Period Two should be coordinated with the length of the Period Two rate levelization period).

[194] Clarification Order, 133 FERC ¶ 61,199 at P 12.

> cost of service factors, including the revenues obtained in a new test period.[195]

159. It is against this backdrop that the ALJ (and subsequently the Commission) addressed "the particulars" of the issue in this proceeding. The ID found that "the Commission has specifically addressed the CE/GP issue in the [Clarification Order] and has limited the inclusion of such costs, to only those costs incurred before the end of the 2004 test period."[196] The Commission affirmed this result, explaining that,

> 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.[197]

160. In its rehearing request, Kern River contends that Opinion No. 486-E erred in its interpretation of Opinion No. 486-D and the Clarification Order by prohibiting Kern River from adjusting its Period Two rate base to include costs incurred after the test-period to replace compressors. In making this argument, Kern River attempts to shoehorn the CE/GP replacement costs incurred after the 2004 test period as within the scope of allowable rate base adjustments described in both Opinion No. 486-D and the Clarification Order. Kern River argues that the Clarification Order expressly affirms that any differences between book depreciation recorded and regulatory depreciation recovered *related to CE/GP replacements* that are not recovered in Period One may be recovered in Period Two.[198] However, such an understanding is at odds with the plain language of the Clarification Order, holding that "Kern River may not include in its regulatory assets new compressor costs that it has incurred after the 2004 test period."[199]

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[195] *Id.* P 14.

[196] ID, 135 FERC ¶ 63,003 at P 1,157 (citing Clarification Order, 133 FERC ¶ 61,199 at P 14).

[197] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 142.

[198] Kern River Request for Rehearing at 27-28 (citing Clarification Order, 133 FERC ¶ 61,199 at PP 12-13).

[199] Clarification Order, 133 FERC ¶ 61,199 at P 14.

Rather, the Clarification Order permitted Kern River to treat as a regulatory asset the amount by which (1) the straight line depreciation of compressors in existence at the end of the test period recorded in Kern River's books exceeded (2) the regulatory depreciation recovered in rates of those same compressors, and the Commission permitted Kern River to add that regulatory asset to its rate base for the purpose of calculating Period Two rates.[200] Accordingly, Kern River cannot support the inclusion of post-test-period CE/GP replacement costs in Period Two rates based on the Clarification Order.

161. Traditional rates and levelized rates are alternative methods of designing rates for recovery of known and measurable capital costs in existence at the end of the test period (test period capital costs). Rate levelization is accomplished by deferring to later years recovery of test period capital costs that would otherwise be recoverable in earlier years. The regulatory asset created by rate levelization is thus the difference between the annual allowance for depreciation of the test period capital costs included in the levelized rates and the straight-line depreciation of the same test period capital costs recorded in the pipeline's books. Use of a levelized rate design does not authorize the pipeline to depart from the Commission's test period regulations and policies. This is true of all of Kern River's capital costs, including its compressor costs. Thus, Kern River may reflect in its Period Two rates any regulatory asset representing delayed recovery of CE/GT capital costs in existence at the end of the 2004 test period but not any such costs incurred after the end of the test period.

162. Kern River next attempts to support the inclusion of post-test-period CE/GP replacement costs in its Period Two rates by suggesting that such costs are somehow envisioned by the 2004 cost of service. Kern River states that these costs "reflect the book depreciation rates established in Opinion Nos. 486 and 486-A, and are based on the replacement intervals, asset costs, and salvage value established in the record for all replacements from Kern River's inception of service through [the] end of the 2004 test period."[201] We do not dispute that Kern River extrapolates the CE/GP replacement costs from certain values in its 2004 cost of service. However, the manner in which Kern River calculates these replacement costs is not the point. It is instead the timing of these costs, i.e., post-test-period, that the Commission has consistently found bars their recovery in Kern River's Period Two rates. Kern River is not permitted to add these post-test-period CE/GP costs to its 2004 cost of service for the purpose of establishing

[200] Clarification Order, 133 FERC ¶ 61,199 at PP 12-14.

[201] Kern River Request for Rehearing at 28-29.

Period Two rates simply because it can trace their development to certain items in its 2004 cost of service.[202]

163. As the Commission explained in Opinion No. 486-E, the rate base in a NGA section 4 rate filing 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.[203] The Commission's regulations permit the following adjustments to the rate base: "[t]he rate factors (volumes, costs, and billing determinants) established during the base period may be adjusted for changes in revenues and costs which are known and measurable with reasonable accuracy at the time of the filing and which will become effective within the adjustment period."[204] Thus, in addition to being known and measurable at the time of the filing, cost adjustments must be effective (i.e., incurred) within the adjustment period. "The Commission has regularly rejected rate adjustments proposed by pipelines for projected events which ultimately did not become effective during the test period."[205] Accordingly, Kern River's attempt to add replacement CE/GP costs incurred after the 2004 test period (made up of the year-long base period plus the nine-month adjustment

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[202] Kern River also suggests that by not allowing it to recover post-test-period CE/GP replacement costs, the Commission would somehow be treating CE/GP costs differently from costs related to all other plant despite Opinion No. 486-A's assurances that CE/GP will be treated the same as other plant. Kern River Request for Rehearing at 33. This argument misses the mark. The Commission is treating CE/GP costs reflected in Kern River's 2004 cost of service the same as other plant costs in that cost of service. The Commission's decision here simply prohibits Kern River from incorporating post-test-period CE/GP replacement costs in its Period Two rates. Were Kern River to propose to include other post-test period plant replacement costs in its Period Two rates, the result would be the same. Accordingly, the Commission is treating CE/GP costs in the same manner it treats other plant costs.

[203] *See* Opinion No. 486-E, 136 FERC ¶ 61,045 at P 145 (citing 18 C.F.R. § 154.303(a)(4)(2012)).

[204] 18 C.F.R. § 154.303(a)(4) (2012).

[205] *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,265, at 62,022 (1999) (citing, *Mojave Pipeline Co.*, 81 FERC ¶ 61,150, at 61,679 (1997) (excluding $800,000 in projected O&M costs that were not in fact incurred during the test period; *Williston Basin Interstate Pipeline Co.*, 71 FERC ¶ 61,019 (1995); *Williams Natural Gas Co.*, 77 FERC ¶ 61,277, at 62,179 (1996) (excluding the cost of stock bonuses not actually vesting in the test period)).

period) to the 2004 cost of service is inconsistent with the Commission's well-established test period regulations and precedent.

164. Kern River also urges the Commission to consider these CE/GP replacement costs as a "transitional matter" that fit within the exception to the general rule that Kern River must base its Period Two rates on the 2004 cost of service.[206] However, Kern River provides no reasoning to support its assertion that CE/GP replacement costs incurred after the 2004 test period are "transitional" such that they should be reflected in Kern River's Period Two rates. Nor can we discern a valid reason to classify CE/GP replacement costs incurred after the 2004 test period as "circumstances unique to the transition from Period One to Period Two rates" that would justify an exception to the general approach of basing Period Two rates on the 2004 cost of service.[207]

165. The fact that Kern River would need to replace compressors, thereby incurring post-test-period CE/GP costs, throughout Period One is not unique to the transition from Period One to Period Two rates. As Kern River itself states, "[t]he evidence of record clearly demonstrates that CE/GP assets have relatively short useful lives and, therefore, are replaced at reasonably foreseeable intervals."[208] Such costs would be incurred whether or not Kern River was transitioning to a new rate Period or maintaining its initial levelized (Period One) rates. Indeed, Kern River has incurred costs to replace CE/GP assets before, during, and after the transition from Period One to Period Two rates. Because these costs would be incurred in any event, they cannot be said to be unique to the transition, such that they justify an adjustment to the Period Two rate base. This is easily contrasted with the regulatory asset reflecting the difference between book and regulatory depreciation for the CE/GP costs in Kern River's rate base as of the end of the test period. That regulatory asset represents test period CE/GT costs whose recovery has been deferred as part of Kern River's rate levelization method. But for the transition from Period One to Period Two rates under Kern River's levelization method, Kern River would have recovered this regulatory asset in its Period One rates. Thus, it is only because of the transition from Period One to Period Two that the regulatory asset remains outstanding and must therefore be accounted for in the calculation of the Period Two rates. Accordingly, this regulatory asset is properly accounted for in Period Two rates as a circumstance unique to the

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[206] Kern River Request for Rehearing at 29.

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

[208] Kern River Request for Rehearing at 28.

transition, whereas the incurrence of new costs after the test period related to compressor replacements (i.e., CE/GP replacement costs) is not.

166. The fact that Kern River may not fully recover its post-test-period CE/GP replacement costs is irrelevant to our decision here.[209] As discussed in Opinion No. 486-E, Kern River was free to propose the replacement methodology it proposes now as part of its initial levelized methodology, in which case Kern River would have needed only to update the replacement rates and costs as part of standard test period analysis.[210] However, Kern River did not do so. Kern River cannot now claim that it is entitled to implement a revised levelization methodology in order to recover these known and predictable CE/GP replacement costs. In contrast, the regulatory asset created by the difference between Kern River's regulatory and book depreciation allowance for CE/GP as it exists at the end of Period One is a creature of Kern River's original levelization methodology. Where this regulatory asset is not fully recovered in Period One, it is reasonable and expected that it would be accounted for in the transition to Period Two. This is why the Commission specifically included it as an exception to the general rule that Kern River's Period Two rates are based on the 2004 cost of service. As the Commission explained in Opinion No. 486-E:

> [T]he 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. 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.[211]

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[209] *See* ID, 135 FERC ¶ 63,003 at P 1,157.

[210] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 146.

[211] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 144.

167. Kern River suggests that the Commission's decision is somehow unfair because it will prevent Kern River from recovering its known and measurable post-test-period CE/GP replacement costs.[212] Kern River again misses the point. Kern River's Period Two rates cannot be evaluated in isolation from the broader context of the 2004 rate case, of which they are an integral part. That is, Kern River cannot isolate certain costs that have increased after the test period and adjust its rate base to include those costs for the purpose of establishing Period Two rates without regard to other costs that may have decreased during the same time frame. We acknowledge that Kern River highlights substantial investments in compressors since its system first came online.[213] We would have no objection to Kern River seeking to recover such costs in a general section 4 rate case, provided they are incurred within the relevant test period. However, our longstanding policy prohibits Kern River from attempting to recover such costs on a limited basis in the context of this case in isolation from cost changes on its system as a whole.[214]

> The Commission generally does not permit pipelines to change any single component of their cost-of-service outside of a general section 4 rate case. A primary reason for this policy is that, while one component of the cost-of-service may have increased, others may have declined. In a general section 4 rate case, all components of the cost-of-service may be considered and any decreases in an individual cost component can be offset against increases in other cost components.[215]

168. This policy is particularly justified in the instant case, where Kern River's 2010 Expansion resulted in more new volumes than costs, providing a significant

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[212] Kern River Request for Rehearing at 30-31.

[213] Kern River Request for Rehearing at 30.

[214] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 144. *See also ANR Pipeline Co.*, 108 FERC ¶ 61,050, at P 14 (2004) ("The Commission generally does not permit pipelines to change one element of their cost-of-service outside of a general section 4 rate case where all elements of the pipeline's cost-of-service may be considered and increases in one element may be affected by decreases in another.").

[215] *ANR Pipeline Co.*, 108 FERC ¶ 61,050 (2004), *order on reh'g and compliance*, 110 FERC ¶ 61,069 at P 18.

economic benefit to Kern River. In the certificate order approving the 2010 Expansion, the Commission granted Kern River a predetermination in favor of rolled in rate treatment of the 2010 Expansion.[216] The Commission's decision was supported by a finding "that the estimated total annual revenues of $34.3 million from the 2010 Expansion service at the 2003 Expansion rates will exceed the $10.4 million total annual costs of the project."[217] Were the Commission to consider the CE/GP replacement costs in establishing Kern River's Period Two rates, it stands to reason that the revenues generated by the 2010 Expansion, as well as myriad other costs and revenues, should be considered as well. However, the Commission declined to consider such additional revenues in Opinion No. 486-E,[218] and upholds that decision here. Accordingly, while Kern River is free to place all of its costs and revenues at issue by filing a new section 4 rate case, that is not the purpose of the instant proceeding.

169. We emphasize that the levelized rate structure employed by Kern River since its inception is accomplished by the pipeline deferring to later years recovery of costs that would otherwise be recoverable early in its life. For this reason, the Commission has repeatedly stated that "[s]ince this trade off is at the heart of any levelization plan, it is inherent in any such plan that the levelized rate will remain in effect for the entire agreed upon period."[219] Accordingly, both Kern River and its customers "should have reasonably anticipated from the beginning that methodology would continue in effect throughout Kern River's life, absent agreement by all parties to modify or eliminate that rate design. Nor should it come as any surprise to the parties that the Commission would hold the parties to their agreement."[220]

170. Finally, because Kern River's request for rehearing of the Clarification Order raises the same issues addressed at length in Opinion No. 486-E and further explained herein, Kern River's request for rehearing of the Clarification Order is denied, for the reasons set forth in Opinion No. 486-E, as further refined and clarified above.

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[216] *Kern River Gas Transmission Co.*, 127 FERC ¶ 61,223, at P 27 (2009).

[217] *Kern River Gas Transmission Co.*, 127 FERC ¶ 61,223 at P 27.

[218] Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 207-218.

[219] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 25 (quoting Opinion No. 486, 117 FERC ¶ 61,077 at P 42).

[220] Opinion No. 486-A, 123 FERC ¶ 61,056 at P 25.

E. Rate Design Volumes

171. In Opinion Nos. 486 through Opinion No. 486-D, the Commission rejected Kern River's proposal to design its Period One Original System rates using reservation and usage billing determinants based on 95 percent of the design capacity of its Original System. While Kern River contended that its proposal was consistent with the so-called 95 percent load factor condition in its Optional Expedited Certificate, 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. Because Kern River had firm contracts (including several seasonal contracts) for somewhat more than 100 percent of the design capacity of the Original System during the test period, the Commission held that Kern River's Period One rates must be designed based on its actual Period One billing determinants.

172. At the hearing on its Period Two rates, Kern River proposed to design those 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. Kern River presented market information for the period 2004-2009 which it asserted demonstrated a significant risk that its shippers would not contract for service during 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.

173. In Opinion No. 486-E, the Commission affirmed the ALJ's finding that Kern River had not justified use of its proposed 95 percent load factor rate design and ordered Kern River to use the 100 percent load factor billing determinants from the 2004 test period.[221] The Commission stated that, because the evidence relied on by Kern River in support of its position covers dates outside the 2004 test period, the threshold matter for decision was whether the load factor issue is an exception to its previous statement in Opinion No. 486-D requiring the use of 2004 test year data to calculate Period Two rates. Specifically, in Opinion No. 486-D, the Commission stated that it continued "to find that the starting point for calculating the Period Two rates in this proceeding <u>must</u> be the cost of service the

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[221] In Opinion Nos. 486 through Opinion No. 486-D, the Commission held that the 95 percent load factor condition in Kern River's Optional Expedited Certificate required that Kern River design its original system rates based upon *at least* 95 percent of its design capacity.

Commission has already determined for Period One based upon the 2004 test year data used in this section 4 rate case."[222]

174. The Commission concluded in Opinion No. 486-E that using evidence outside the scope of the 2004 test period would permit Kern River to selectively address, using more recent information, one element of its Period Two rate design without subjecting other Period Two rate design elements to the same scrutiny. Such an approach would allow Kern River to avoid the risk of unfavorable adjustments. As explained in Opinion No. 486-E and previous opinions, 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.[223] The Commission has consistently rejected the use of data outside the Period One test period in this proceeding with only very narrow and limited exceptions.

175. The Commission rejected Kern River's arguments that the expiration of its Period One contracts supported use of a 95 percent load factor. The Commission explained that the fact that Kern River's Period One contracts will expire before Period Two begins did not distinguish it from any other pipeline whose existing contracts are expiring over a certain period of time. The Commission noted, however, that Kern River had the advantage of offering to extend its existing contracts at significantly lower rates in addition to its existing recourse rates.[224] The Commission also stated that, while Kern River emphasized 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.

176. Opinion No. 486-E noted that, while the Commission generally does not consider post-test period evidence, Opinion No. 486-D had stated:

> Kern River's Period Two rates must be designed based upon some projection of the billing determinants that will be in effect during Period Two. Accordingly, the parties may address at hearing whether the volumes used to design the Period Two rates and allocate costs

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

[223] *Id*. P 193.

[224] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 167.

> 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.[225]

Opinion No. 486-E stated that the parties and the ALJ appeared to have 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. Therefore, the Commission stated that it would 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 test period.[226]

177. The Commission considered three arguments raised by Kern River in support of its proposed use of 95 percent load factor billing determinants. Kern River argued that it faced greater contract risk in Period Two due to (1) increased pipeline competition, particularly from 1.5 Bcf/d Ruby Pipeline (Ruby) to northern California, (2) 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 and lowering the value of Kern River's transportation capacity below the level of its projected Period Two rates, and (3) 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. The Commission noted that all of Kern River's arguments were based on information far outside the 2004 test period. The Commission determined that these arguments would be relevant only if Kern River presented compelling testimony that the Commission should adopt what is in essence a new test period to determine the Period Two load factor.[227]

178. The Commission found that Kern River's post-test period evidence and arguments rested primarily upon assumptions, projections, and potential occurrences. The Commission concluded that such speculation does not constitute record evidence that is compelling enough to justify departing from the holding stated in Opinion No. 486-D "that the starting point for calculating the Period Two

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

[226] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 168.

[227] *Id*. P 172. Under 18 C.F.R § 154.303(d) (2012), the Commission may allow reasonable 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."

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."[228] On the other hand, the post-test period data presented by intervenors, which showed that Kern River's throughput consistently met or exceeded 100 percent load factor during the period from 2004 to 2010, would validate the test period projections. 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.[229] 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.

179. The Commission stated that, 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.

Request for Rehearing

180. On rehearing, Kern River challenges the Commission's use of the test period approach to determine the appropriate billing determinants for Period Two and its finding that Kern River provided no evidence based on the 2004 test period data to support a change to the use of the 2004 test period determinants.[230] Among other things, Kern River complains that it is being held to an unfair retroactive imposition of evidentiary constraints.[231]

181. Kern River argues that its failure to offer evidence from the 2004 test period was based on the Commission's "explicit" acknowledgement in Opinion No. 486-D that the projection of design volumes for Period Two rates was an issue unique to the transition from Period One to Period Two and therefore need not be confined to 2004 data.[232] Kern River states that it is hard to conceive of an issue

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

[229] ID, 135 FERC ¶ 63,003 at PP 1030, 1032, 1034-1036.

[230] No other party requested rehearing on this issue.

[231] Kern River Request for Rehearing at 8.

[232] *Id.*

that is more unique to the transition from Period One to Period Two than billing determinants.

182. Kern River further argues that given the absence of any contract subscriptions for Period Two, the Commission cannot insist that projecting subscriptions for the 100 percent unsubscribed Period Two is properly controlled by evidence relevant only to the fully-subscribed Period One.[233] Kern River also challenges the Commission's statement that the fact some of Kern River's contracts "might" expire is irrelevant to the determination of the billing determinants, arguing that *all* of its currently effective contracts will expire.

183. Kern River also contends that its Period Two rates were required to be filed several years before their effective dates which detracts from the validity of the test period approach. The company argues that using 2004 data to establish billing determinants for Period Two service which does not commence until 2011, is hardly anymore compliant with test period adjustments than using updated information for the time in which the Period Two rates will actually be charged.[234]

184. Kern River also seeks rehearing of what it deems the Commission's "alternative" rationale for adopting 100 percent load factor billing determinants for Period Two. Kern River is referring to the Commission's review of the out of test period evidence relating to market information for the period 2004-2009 submitted by Kern River and other parties. Kern River seeks rehearing of the Commission's rejection of its arguments based on post-test period evidence that it faces increased risk in Period Two which supports a downward adjustment to its billing determinants.[235]

<u>Commission Determination</u>

185. The Commission denies rehearing on this issue. As discussed below, our requirement that Kern River design its Period Two rates based upon its actual 2004 test period billing determinants is consistent with our test period regulations and policies. Kern River has provided no basis to depart from those policies in this case. Moreover, our acceptance of its proposal to require shippers to make binding contractual elections whether to take Period Two service one year before the expiration of their Period One contracts provides Kern River an opportunity to file a general section 4 rate case reflecting those elections and any efforts to

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[233] Kern River Request for Rehearing at 9.

[234] Kern River Request for Rehearing at 10.

[235] Kern River Request for Rehearing at 11-19.

remarket turned-back Period One capacity in time for revised rates to take effect contemporaneously with the start of the relevant Period Two.

186. As discussed in the preceding section, the Commission's regulations require that a pipeline's rates be based on actual data for a one-year base period, as adjusted to reflect known and measurable changes within the following nine months (adjustment period).[236] Section 154.303(a)(4) of the Commission's regulations requires that the changes that a pipeline projects in its filing "become effective within the adjustment period." Consistent with that regulation, the Commission generally rejects rate adjustments proposed by pipelines for projected events which ultimately did not become effective during the test period. For example, in *Williston*,[237] the pipeline proposed to reduce its billing determinants to reflect certain bypasses of its system which it projected would occur during the test period. However, at the end of the test period, the bypasses were the subject of certain ongoing litigation, and they did not actually occur until several months after the end of the test period. The Commission rejected the pipeline's proposed reduction in billing determinants, because the bypasses had not become effective at the end of the test period. In addition, because litigation concerning the bypasses had not concluded as of the end of the test period, there was no certainty at that time that the bypasses would occur.

187. In *Williston*, the Commission recognized that it has occasionally permitted the use of post-test period data to establish a pipeline's rates.[238] However, as the Commission explained, the Commission generally requires that the post-test period data demonstrate that projections based on the test period data will be seriously in error. In addition, as illustrated by the two cases cited by *Williston*, when the Commission has used post-test period data, the data in question has been record evidence of changes in the pipeline's billing determinants or costs that have actually occurred by the time of the hearing, not evidence of general market conditions which might affect the pipeline's billing determinants or costs at some

[236] See 18 C.F.R. § 154.303(a) (2012). The test period for Kern River consists of a base period of the 12 months ending January 31, 2004, with a nine month adjustment period through October 31, 2004.

[237] *Williston Basin Interstate Pipeline Company*, 87 FERC 62,020-2.

[238] *Id*. at 62,022 (citing *DistriGas of Mass Corp. v. FERC*, 737 F.2d 1208, 1220 (1st Cir. 1984) (*DistriGas*); and *National Fuel Gas Supply Corp*., 51 FERC ¶ 61,122, at 61,334 and n. 53 (1990)). *Accord, Enbridge Pipelines (KPC)*, 102 FERC ¶ 61,310, at P 101 (2003); *Northwest Pipeline Corp.*, 92 FERC ¶ 61,287, at 61,999-200 (2000).

point in the future after the hearing. In *DistriGas*, the hearing record contained evidence that in the year after the test period, DistriGas had sold about 45 percent more gas than in the last year of the test period, and therefore use of the test period data would have produced rates 45 percent higher than the post-test period data suggested was appropriate. In *National Fuel*, a reduction in the federal income tax rate from 47 percent to 34 percent had been enacted during the test period, but did not take effect until after the test period. The Commission held that the reduction in the tax rate, which had become effective before the ALJ's initial decision, had a significant effect on the pipeline's rates and that the pipeline had had the opportunity at the hearing to present evidence of offsetting cost increases.

188. Opinion No. 486-E's requirement that Kern River design its Period Two rates based on the same actual 2004 test period billing determinants as used to design Kern River's Period One rates is fully consistent with these policies. As the Commission found in Opinion No. 486-E, 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 with contracts in effect which will expire at various future dates after the end of the test period. In this regard, Kern River's only distinction from other gas pipelines is that as its Period One contracts expire during the period September 30, 2011 and through April 30, 2018, it will offer the shippers with expiring contracts significantly lower rates.[239]

189. At the hearing, Kern River presented evidence concerning various market developments between the end of the test period and the time of the hearing, such as the construction of the Ruby Pipeline, which it asserted have significantly increased its risk that shippers with Period One contracts will choose not enter into contracts for service during Period Two. However, even accepting Kern River's assertion of increased market risk, there is no more justification here to reduce Kern River's billing determinants below test period levels than there was in *Williston*, where a bypass of the pipeline's system was planned but had not taken effect by the end of the test period. Moreover, this case is distinguishable from *DistriGas* and *National Fuel*, because here the loss of contracts had still not occurred as of the date of the hearing, whereas in *DistriGas* the increase in sales had occurred and in *National Fuel* the change in the tax law had occurred. By contrast, here Kern River seeks to have us reflect in rates projected changes in billing determinants which had not occurred as of the date the hearing was completed or Opinion No. 486-E issued, and which were not certain to occur as of that time. As noted in Opinion No. 486-E, evidence proffered by Shippers at the

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

hearing demonstrates that Kern River's throughput has met or exceeded 100 percent load factor for the years 2004-2009 and 2010.[240]

190. We recognize that, since the issuance of Opinion No. 486-E, the two 10-year Original System shippers with contracts expiring on September 30, 2011 elected not to contract for service during Period Two. In addition, six out of the seven 10-year 2003 Expansion shippers with contracts expiring April 30, 2013 also elected not to take service during Period Two. Kern River states that the two 10-year Period One contracts which have been renewed, one for service on the 2002 Expansion and one for service on the 2003 Expansion, represent only 16.3 percent of the Period One capacity for which contracts have expired thus far.[241] However, we have no information as to how much of the turned-back Period One capacity Kern River may have sold to other shippers.

191. These facts in no way our undercut our decision to follow our standard test period policies in projecting the billing determinants to be used in designing Kern River's Period Two rates. As the Commission explained in *Williston*, a primary reason for our test period policy is that:

> it is likely that many changes will occur to a pipeline's anticipated cost and volumes after the test period. These changes may include increases in throughput or decreases in the cost of service that offset any decreases in throughput that occur. Taking such post test period changes into account is inconsistent with the Commission's test period regulations for gas pipelines. The Commission cannot allow pipelines to make adjustments that will favor the pipeline, if they eventually come to pass after the test period, since the pipelines would be unlikely to project changes unfavorable to them such as increases in throughput and decreases in costs.[242]

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[240] Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 162,170.

[241] Kern River Response to Data Request in Docket No. RP13-199-000. The Period One contracts which have expired so far represent only about 10 percent of Kern River's total capacity subject to Period One contracts. The remaining 90 percent of such capacity is subject to 15-year contracts which do not start expiring until September 30, 2016.

[242] *Williston*, 87 FERC at 62,022.

192. Here, Kern River seeks permission to reflect in its Period Two rates a projected post-test period reduction in its billing determinants for the subject services, without considering any other post-test period changes on its system which could offset the effect of the projected reduction in billing determinants. As pointed out in the preceding section, Kern River's 2010 Expansion resulted in more new volumes than costs, providing a significant economic benefit to Kern River. If reduced billing determinants resulting from the expiration of Period One contracts on the Original System and the 2002 and 2003 Expansions are to be taken into account, then the revenues generated by the 2010 Expansion, as well as all other changes in Kern River's costs and revenues, including any revenue Kern River obtains by remarketing any turned-back Period One capacity, should also be considered.[243]

193. As the Commission stated in Opinion No. 486-E, if use of the 2004 test period data on which all the rates approved in this rate case are based no longer results in just and reasonable rates, Kern River's remedy under the NGA is the same as for any pipeline which loses customers due to changes in its market: file a new section 4 rate case using a test period that conforms to the Commission's test period regulations and reflect the reduced demand for its services. Such a rate case would place before the Commission all changes in Kern River's costs and revenues which have occurred since 2004 and reflect current market demand for Kern River's services. Requiring Kern River to file a new section 4 rate case for this purpose is particularly appropriate, because as discussed later in this order, we are approving Kern River's tariff language, which took effect on September 1, 2011, requiring shippers to make binding contractual elections whether to take Period Two service one year before the expiration of their Period One contracts. Thus, Kern River had notice as of April 30, 2012, that six out of its seven 2003 Expansion shippers with contracts expiring on April 30, 2013 would not be entering into contracts for Period Two service. Similarly, Kern River's various shippers with 15-year contracts expiring beginning in September 30, 2016 will have to make binding elections whether to take service in Period Two one year before their contracts expire.

194. The 12-month notice of contract elections gives Kern River ample opportunity to file a general section 4 rate case reflecting those elections and any efforts to remarket turned-back Period One capacity in time for revised rates to

[243] The Commission notes that Kern River has consistently opposed the request of its shippers to expand this section 5 proceeding to consider matters such as whether the costs and revenues of the 2010 Expansion should be rolled into Kern River's rates, and the Commission rejected the shippers' request in Opinion No. 486-E.

take effect contemporaneously with the start of the relevant Period Two. For example, if Kern River filed a general section 4 rate case six months before the expiration of the Period One contracts and used a base period ending two months before the filing, the adjustment period would extend to one month past the effective date of the rate case filing even assuming a five month suspension. Thus, the adjustment period would reflect both the Period One contract expirations and any successful remarketing of the turned-back capacity by Kern River during the one-year period after Period One shippers elected not to take service during Period Two. Accordingly, while Kern River complains about the use of 2004 data to establish billing determinants for Period Two service which does not commence until 2011 and later, the use of that data is solely the function of Kern River's own decision not to file a new section 4 rate case since 2004. Kern River can at any time obtain Period Two rates based upon more current data by filing a new section 4 rate case.

195. We also reject Kern River's contention that our refusal to take into account post-2004 test period data in resolving the billing determinant issue is contrary to Opinion No. 486-D. In that order, we stated 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."[244] We further stated 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."[245] Opinion No. 486-D listed three adjustments which would qualify as arising out of circumstances unique to the transition from Period One to Period Two. These were (1) the fact Period Two rates must return the excess recovery of depreciation expenses existing at the end of Period One, (2) the use of a 100 percent equity structure for Period Two, and (3) a possible adjustment to Kern River's return on equity based upon the changed capital structure.

196. With regard to rate design volumes, Opinion No. 486-D stated as follows:

> [T]he Commission has required Kern River's Period One rates to be designed based on its actual Period One billing determinants. However, as Kern River points out in its compliance filing, its Period One contracts expire at the end of Period One and it does

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

[245] *Id*.

> not currently have contracts with any shippers for Period Two. Kern River's Period Two rates must be designed based upon some projection of the billing determinants that will be in effect during Period Two. Accordingly, the parties may address at hearing whether the volumes used to design the Period Two rates and allocate costs should be based upon 95 percent of Kern River's design capacity, a projection that its Period One contracts will be renewed, or some other basis.[246]

197. Kern River misinterprets Opinion No. 486-D, when it relies on this language to assert that we held that the projection of rate design volumes for Period Two is an issue unique to the transition from Period One to Period Two and therefore need not be confined to 2004 test period data. In making the statements quoted above concerning billing determinants, the Commission carefully avoided making any merits decision on any issue concerning how Kern River's Period Two billing determinants should be projected or what evidence should be used. Rather, the Commission allowed all parties to present whatever evidence they desired at the hearing and argue for or against the use of either 2004 test period data or post-2004 test period data, so that the Commission could decide this issue based on a fully developed record. The Commission was simply unwilling to prejudge the outcome of this issue before the hearing and before a further airing of the issue at the hearing.

198. Contrary to Kern River's contentions on rehearing, we now find that the expiration of the Period One contracts is not a circumstance unique to the transition from Period One to Period Two in the same manner as the other three possible adjustments identified by Opinion No. 486-D. Each of those rate adjustments was inherent in Kern River's levelized rate methodology and, in fact, could be projected based on 2004 test period information. As previously described, that methodology provided for Kern River to have accrued a regulatory liability by the end of Period One which is calculated by projections based on 2004 test period data. Similarly, that methodology provided for Kern River to have a 100 percent equity capital structure at the end of Period One, and, when the Commission originally approved Kern River's levelized rate methodology, the Commission expressly reserved the right to consider an adjustment to Kern River's return on equity at the end of Period One in light of the change to a 100 percent equity capital structure.

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[246] *Id*. P 198.

199. Thus, adjustments from the 2004 test period data to subtract the regulatory liability from the Period Two starting rate base, reflect a 100 percent equity capital structure, and consider whether the change in capital structure justifies an adjustment to return on equity are similar to the adjustment we required in *National Fuel* to reflect the post-test period reduction in the federal income tax rate pursuant to a law enacted during the test period. In each of these cases, the adjustment automatically follows from a statutory or regulatory requirement that was effective during the test period – in *National Fuel*, the change in the tax law, and in this case, the conditions concerning rate design established in Kern River's optional expedited certificate proceeding.

200. By contrast, it does not follow automatically from Kern River's levelized rate methodology that shippers will not renew their contracts in Period Two. That is simply an option provided to shippers as a result of the fact their Period One contracts expire. But that circumstance is no different from any other situation in which a shipper's contract expires. No regulatory requirement in effect during the 2004 test period requires a projection that Period One shippers will not renew their contracts, similar to the manner in which optional expedited certificate conditions justify projecting that Kern River will have a regulatory liability and a 100 percent equity capital structure at the end of Period One.

201. Kern River further asserts that by now limiting consideration of Period Two billing determinants to only Period One test period data, the Commission has imposed a new evidentiary standard. Kern River therefore requests that the Commission must afford it an opportunity to meet such a new standard. However, Opinion No. 486-D clearly stated that the 2004 test period would be the starting point for the determination of all aspects of the Period Two rates and that parties could argue at the hearing for any method of determining the Period Two billing determinants. Hence, Kern River was not misled into a belief that the Commission intended to use post-2004 evidence to set the level of billing determinants and was not denied an opportunity to present evidence based on the 2004 test period data.

202. Thus, Kern River was not foreclosed, despite its protestations, from arguing for a reduction in billing determinants based on events during the 2004 test period. As noted above, however, the 2004 test period data show that Kern River had actual billing determinants which met or exceeded 100 percent of its design capacity. It is this fact, not any evidentiary prohibition of the Commission, which serves to explain why Kern River did not argue for a reduction in billing determinants based on the 2004 test period data. Moreover, Kern River has not provided any indication in its rehearing request what evidence it would provide based on the 2004 test period, if given the opportunity to do so.

203. The Commission concludes that, on rehearing, Kern River has raised no new arguments or identified any additional compelling evidence of record which would warrant any change to our determination in Opinion No. 486-E that Kern River's Period Two rates should be derived based on 100 percent load factor billing determinants. In the event Kern River should find itself unable to recover its cost of service, it always has the option to make an NGA section four rate increase filing.

F. <u>Capital Structure</u>

204. In Opinion No. 486-E, the Commission approved Kern River's proposal to use a 100 percent equity capital structure in calculating its Period Two rates.[247] The Commission explained that it had clarified in the August 1992 Order in the optional expedited certificate proceeding that Kern River would be permitted to utilize an 100 percent equity capital structure during Period Two, because the levelized rate structure approved in that proceeding was intended to permit Kern River to recover all its debt capital during Period One.[248]

205. Opinion No. 486-E affirmed the ALJ's rejection of contentions that a 100 percent equity capital structure should not be reflected in the Period Two rates of any customer group until Kern River pays off its entire aggregate debt, currently due to occur in 2018. The Commission further elaborated that:

> 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 that 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.[249] 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,

[247] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 147 (citing, Opinion No. 486-D, 129 FERC ¶ 61,062 at P 195).

[248] *Id.* (citing, August 1992 Order, 60 FERC at 61,437).

[249] ID, 135 FERC ¶ 63,033 at PP 407, 829, 835, 1115.

> 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.[250]

206. Opinion No. 486-E also recognized that it had previously stated in Opinion No. 486-A that, if Kern River refinances its debt and the debt 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.[251] However, the Commission stated that no such refinancing had 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.

Request for Rehearing

207. BP argues that Opinion No. 486-E erred in approving a 100 percent equity capital structure for Period Two, while keeping its return on equity at 11.55 percent. BP asserts that this determination creates a mismatch between the capital structure used on the one hand to justify Kern River's equity return, and on the other, to compute the proportion of debt in calculating the overall weighting of capital cost components.

208. BP argues that it is longstanding Commission policy to use a pipeline's actual capital structure when deriving rates.[252] Thus, BP argues that, because Kern River will have debt outstanding during the Original System 10 Year Shippers' Period Two levelization period (beginning October 1, 2011), the Commission should derive Kern River's rates using its actual capital structure and adopt the latest available actual capitalization (56 percent debt, 44 percent equity) for its calculations.[253]

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[250] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 156.

[251] *Id.* (citing, Opinion No. 486-A, 123 FERC ¶ 61,056 at P 46).

[252] BP Rehearing Request at p. 38 (citing, *Transcontinental Gas Pipeline Corp*., Opinion No. 414, 80 FERC ¶ 61,157, at 61,667 (1997), Opinion No. 414-A, 84 FERC ¶ 61,084, at 61,415 (1998).

[253] BP Rehearing Request at pp. 38, 43 (citing, Exh. No. BP-P2-7 at 9:18-19).

209. BP argues that Opinion No. 486-E improperly relied on the August 1992 Order in the optional expedited certificate proceeding granting Kern River's request to clarify that its Period Two rates could be designed using a 100 percent equity structure.[254] BP argues that the Commission failed to take into account the changed circumstances created by the ET Settlement. For example, BP asserts that the August 1992 Certificate order found that "the depreciation accumulated during the first 15 years of the project [i.e. Period One] will be used to retire debt principal, resulting, after 15 years [i.e. Period One], in projects capitalized with 100 percent equity."[255] BP asserts that the "debt attributable to the original system construction" was subsequently repaid during the refinancing provided for in the ET Settlement.[256] Accordingly, BP asserts that the term of the new debt extends beyond the contract term of the Original System 10-Year Shippers, and that Kern River's shippers no longer exit Period One on a single date, as assumed by the original certificate proceeding.

210. BP asserts that Opinion No. 486-A projected each class of shippers' assigned debt balance over their Period One levelization period according to that rate class's allocated share of Kern River's depreciation expenses, rather than Kern River's actual debt repayment schedule.[257] BP reasons that such a methodology was not based on actual, contractually mandated debt payments, but was a "projection" of each shipper class's assigned debt balance repayments over the levelization period.

211. BP points out that Opinion No. 486-B responded to its request for rehearing of Opinion No. 486-A, finding that "if Kern River retains debt in its capital structure during the time the Period Two rates are being collected, the level of Period Two rates must be adjusted to reflect any benefits to shippers from such action but not any detriment to shippers."[258] BP argues that this promise cannot rely on a projection which assumes that the debt was repaid before the end of each shipper's Period One. Rather, an analysis of the amount of debt actually retained

[254] BP Rehearing Request at p. 37 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 151).

[255] *Id.* (citing, *Kern River Gas Transmission Co.*, 60 FERC ¶ 61,123 at 61,437 (1992)).

[256] *Id.* (citing, *ET Settlement Order*, 92 FERC ¶ 61,061 at 61,159).

[257] BP Rehearing Request at p. 39 (citing, Opinion No. 486-A, 123 FERC ¶ 61,056 at P 146).

[258] *Id*. at p. 38 (citing, Opinion No. 486-B, 126 FERC ¶ 61,034 at P 174).

by Kern River is necessary. BP contends that Kern River's actual experience and its projections reveal that debt assigned to Original System 10 Year Shippers continues in existence during Period Two.[259]

212. BP states that in the ET Settlement order the Commission stated that the relevant portion of the refinanced debt for each customer class was supposed to be retired over the period of the respective extended contracts and therefore for the Original System 10 Year shippers the debt would have to be retired by September 30, 2011. However, BP argues that by the end of 2011, Kern River will have failed to repay all of the Original System 10-year Shipper's portion of the debt despite the fact that the Period One contracts will have terminated. BP asserts that this permits Kern River to receive a return on equity on this debt while only incurring the lower debt costs. BP maintains that rolled-in shippers must continue to pay this debt. However, BP maintains that having paid these debt related costs such shippers are entitled to a capital structure that reflects such debt. BP states that the original facilities shippers entering Period Two must receive the benefit of the debt capitalization.

Commission Determination

213. The Commission denies BP's request for rehearing on this issue. As the Commission explained in Opinion No. 486-D, its standard capital structure policies do not apply to Kern River's Period Two rates, because use of a 100 percent equity capital structure for Period Two is part of the rate design principles underlying Kern River's optional expedited certificate:

> 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.[260]

[259] *Id*. at pp. 40-41.

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

In Opinion No. 486-E, the Commission reaffirmed this holding.[261]

214. The Commission rejects BP's contention that this holding fails to take into account that the ET Settlement changed circumstances relied upon by the Commission in its August 1992 Certificate order. The Commission recognizes that Kern River is not required to repay the new loans it entered into as a result of the ET Settlement until 2018. Therefore, Kern River had not repaid all its debt as of the September 30, 2011 termination of the 10-year extended term Period One contract BP entered into pursuant to the ET settlement. However, this does not alter the fact that BP's extended term contract required it to pay its allocated share of the 70 percent of Kern River's original invested capital by the end of its Period One contract. Therefore, BP's Period Two rates are properly designed based solely on its allocated share of the 30 percent of Kern River's invested capital that was financed by equity.

215. As the Commission explained in Opinion No. 486-E:

> 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 [debt] 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.[262]

216. BP requests that, in designing its Period Two rates, the Commission take into account the fact that Kern River has not fully paid off all its debt and thus include in BP's Period Two rates an overall rate of return on investment reflecting the lower cost of debt. However, if the Commission were to do this, consistency would require that the Commission also include the unpaid debt in the rate base

[261] *Id*. P 151.

[262] *Id*. P 152 (emphasis added).

used to calculate BP's Period Two rates. As a result, BP's Period Two rates would be designed using a rate base reflecting both the 30 percent of Kern River's original invested capital financed by equity and the additional amount of its original invested capital associated with its still unpaid debt. This would lead to higher Period Two rates for BP, than rates based solely on the 30 percent of invested capital financed by equity. BP cannot have it both ways, and simultaneously receive the benefit of both (1) a rate base reduction to only 30 percent of Kern River's original invested capital based on the fact BP has paid its allocated share of the 70 percent of the rate base financed by debt, and (2) the lower cost of debt in calculating the overall return on that rate base to include in BP's rates.

217. The fact that Period One rates remain in effect for other customer groups when Period Two rates are implemented for customers whose Period One contracts have expired has no effect on the appropriate design of the Period Two rates for those customers whose Period One contracts have expired. That is because these rates are derived based upon the individual customer's allocated share of Kern River's rate base, equity, and deferrals at the initiation of Period Two.[263] While the ET Settlement provided for extensions in the terms of the shippers' Period One contracts and for Kern River to refinance its debt, the ET Settlement did not alter the requirement that each shipper pay a levelized rate during Period One designed to recover its allocated share of the 70 percent of Kern River's invested capital financed by debt during the terms of its Period One contract. Therefore, the ET Settlement did not undermine the basis for our clarification in the August 1992 Order in the optional expedited certificate proceeding that Kern River's Period Two rates should be designed using a 100 percent equity capital structure -- that the net rate base to be reflected in each shipper's Period Two rates would be financed entirely by equity.

218. In addition, BP has argued that because Kern River has not paid off all of its debt, a 100 percent equity capital structure will allow Kern River to earn an excessive return on its unpaid debt. BP asserts that such a return will be higher than the return that Kern River is entitled to because the debt is cheaper than the equity, but given the Commission's determination regarding a 100 percent capital structure for Period Two rates the outstanding debt will earn a return equal to the equity return. However, because Period Two rates will be constructed for each shipper based only upon 30 percent of the original capital financed by equity, whether all the outstanding debt has been paid by Kern River is not relevant to the derivation of the Period Two rates for each shipper because the outstanding debt will not be used in the calculation of the Period Two rates for the shipper. As the

[263] *Id*. at PP 156-157.

Commission has pointed out above, each shippers's Period Two rates will reflect its payment of its share of the 70 percent of Kern River's invested capital from the date Period Two commences for that shipper, and the Period Two rates for that shipper will reflect a 100 percent equity capital structure.[264]

219. Accordingly, the Commission finds BP arguments do not compel the Commission to reconsider its original determinations of this matter.

G. Adjustments to Return on Equity

220. In Opinion No. 486-D, the Commission stated that, consistent with the August 1992 Order and Opinion No. 486-C, the parties could examine at the hearing 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. Opinion No. 486-D required that any testimony supporting any adjustment above or below the median must be based on 2004 test period information and held that the parties could not change the proxy group or the equity range of 8.8 to 13.0 percent adopted by Opinion No. 486-B.[265]

221. At the hearing, Kern River proposed to increase the return on equity to 13.00 percent, the top of the range, while the Shipper Parties and Trial Staff advocated a reduction to 8.8 percent, the bottom of the range. The Initial Decision found that neither Kern River nor the Shipper Parties and Trial Staff had justified a departure from the median.[266]

222. In Opinion No. 486-E, the Commission affirmed the ALJ's finding that Kern River's return on equity for Period Two should continue to be 11.55 percent.[267] As stated in Opinion No. 486-E, the Commission has a strong presumption that most regulated pipelines fall with a broad range of average risk absent highly unusual circumstances. Therefore, in order to adjust the return on equity from the median for the Period Two rates, the Commission would therefore have to find that an investor in 2004 would conclude, based on the information available at that time, that unusual circumstances between 2011-2018 would exist such that the investor would require a return on equity higher than the median. Such a finding would require the presentation of compelling evidence such that an

[264] *Id*. P 152 (emphasis added).

[265] Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 196-197.

[266] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 192.

[267] *Id*. at P 206.

investor would perceive Kern River to have a greater or lower average risk during the 2011-2018 time period.[268]

Requests for Rehearing

Kern River

223. On rehearing, Kern River argues that the Commission erred in refusing to adjust Kern River's Period Two return on equity to 13.00 percent based on the Commission's assumptions of "investor perspective" in 2004.[269]

224. Kern River explains that its witness, Dr. Carpenter, testified in support of an upward adjustment to the median. According to Kern River, Dr. Carpenter attempted to quantify and account for the unprecedented capital market risk associated with establishing an equity return *today* for investment associated with service at Period Two rates that will not commence for several years into the future.[270] Kern River argues that the Commission's requirement to use only 2004 test period data fails to recognize the time lag between current investment and commencement of Period Two service. Such a time lag necessitates that investors receive higher equity returns in order to compensate for the incremental risks associated with establishing rates so far in advance.[271]

225. Kern River further argues that the Commission's "exclusive reliance" on 2004 data to establish the Period Two return on equity and its application of this standard as the basis for rejecting its witness's proposed risk premium adjustment does not withstand reason. As it argued with regard to the level of its billing determinants, Kern River states that its ability to attract equity capital for Period Two investment is clearly an issue unique to the transition from Period One to Period Two.[272]

226. Kern River states that it is illogical and inconsistent for the Commission to consider Kern River's reduced Period Two financial risk without also accounting

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[268] *Id*. at P 201.

[269] Kern River Request for Rehearing at 4, 21.

[270] *Id*. at 22 (emphasis in original).

[271] *Id*.

[272] *Id*.

for the capital market risk associated with attracting Period Two investment.[273] Kern River avers that the Commission's assumption that investors would have understood the effect of levelization and that the resultant reduced financial risk would mitigate Kern River's contracting risk is unsupported at best. Kern River claims that the Commission never clearly stated that Period Two rates must be levelized until Opinion No. 486-C was issued in 2009.[274]

227. Finally, Kern River states that when the Commission did not adopt Kern River's request to adjust its billing determinants downward in Opinion No. 486-E, the Commission indicated that any increased risk associated with Period Two re-contracting should be addressed in determining the return on equity. Kern River asserts that the Commission in Opinion No. 486-E nonetheless rejected any contemporaneous assessment as "not properly before the Commission," citing Paragraph 200 of Opinion No. 486-E.[275] Kern River states that the Commission improperly treats Kern River's Period Two risk as no different from any other pipeline and argues that the critical difference is that rates are being set years in advance of their effective date and for services that have no contract subscriptions.[276]

BP

228. BP argues that given Kern River's average or lower business risk and its non-existent financial risk, the return on equity should be set at the low end of the range of reasonableness, or 8.8 percent.[277]

229. BP argues that if the Commission is to derive Kern River's Period Two rates using a 100 percent equity ratio, it must also evaluate Kern River's risk based on that capital structure.[278] BP points to the Commission's statement in Opinion No. 486-E that investors would recognize that Kern River's capital structure would gradually evolve to a 100 percent equity structure beginning in 2011. BP interprets this statement to mean that the Commission found that Kern River's

[273] *Id*. at 23.

[274] *Id*.

[275] *Id*. at 24.

[276] *Id*.at 24.

[277] BP request for rehearing at 52-53.

[278] *Id*. at 45.

financial risk was not reduced as of 2011. Thus, BP concludes that the Commission in its risk evaluation specifically considered Period One debt that was still outstanding through 2015 rather than evaluating Kern River's risk solely upon its finding the Kern River's capital structure should be composed of 100 percent equity. By doing so, BP argues that the Commission deprives shippers of the benefit of a lower return on equity due to the presence of debt in the evolving capital structure.[279]

230. BP states this approach is at odds with the Commission's previous holdings in the Order No. 486 series of cases as well as other Commission precedents on how to evaluate financial risk for a pipeline.[280] BP argues that the Commission failed to properly match, or synchronize, the imputed Period Two capital structure used for ratemaking with the capital structure used to evaluate Kern River's risk. BP states when evaluating a pipeline's risk to derive the return on equity, the Commission considers financial risk associated with the capital structure it uses for developing rates at issue, not any other capital structure.[281]

231. However, BP also states that an alternative is to assess Kern River's riskiness based upon what it terms the "projected" 100 percent equity capitalization used in developing the Period Two rates. Under this alternative, BP argues that the Commission must consider Kern River's relative financial risk based upon the Period Two 100 percent equity capital structure.[282]

232. BP states that a pipeline's equity ratio (and inversely its debt) is the primary means for assessing financial risk, noting that the Commission has found that equity ratios as low as 60 percent to be above average and demonstrate low financial risk.[283] BP asserts that the issue is whether considering that the Commission has found that Kern River has average business risk together with its "highly unusual" 100 percent equity capital structure, an adjustment to equity is required.[284]

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[279] *Id*. at 45-46.

[280] *Id*. at 45.

[281] *Id*. at 46.

[282] *Id*. at 48.

[283] *Id*. at 49-50.

[284] *Id*. at 50-51.

233. BP cites Commission precedent where the Commission decided not to adjust a pipeline's return on equity because the pipeline's equity ratio was not anomalous when compared to other equity ratios approved by the Commission.[285] BP argues that in contrast, Kern River has the most anomalous capital structure possible, even when compared to high equity ratios that the Commission has permitted in other proceedings.[286]

SCGC

234. Southern California Generation Coalition (SCGC), like BP, also argues that because the Commission decided in Opinion No. 486-E that Kern River should use a 100 percent equity capital structure for setting Period Two rates, it should have also determined the return on equity based upon the 2004 test period information which includes assumption of a 100 percent equity capital structure. SCGC argues that the Commission incorrectly assumed a composite equity structure in setting Kern River's return on equity at 11.55 percent.[287]

235. SCGC claims the Commission failed to recognize the need to assume a 100 percent capital structure to determine the return on equity, pointing to Opinion No. 486-E's discussion that Kern River's capital structure would evolve, gradually reducing its financial risk and that it would be viewed in 2004 as part of a composite equity subject to generic business risks.[288] SCGC states that because the Commission decided to require Period Two rates to be designed on the basis of 100 percent equity capital structure, it erred in stating that investors would have perceived a composite equity structure.[289]

236. SCGC asserts that Opinion No. 486-E reasons that the "fact is that the financial and business risks attributed to some 88 percent of Period One contracts remain in effect through the end of 2015 would trend the required ROE toward the median…" SCGC states that it is irrelevant that 88 percent of Period One contracts remain in effect through 2015 for the purposes of setting the Period Two

[285] *Id*. at 51-52.

[286] *Id*. at 50-52 (citing, *Williams Natural Gas Co*., 77 FERC ¶ 61,277 (1996), *order on reh'g*, 80 FERC ¶ 61,158 (1997),*order on reh'g*, 84 FERC ¶ 61,080 (1998), *order on reh'g*, 86 FERC ¶ 61, 232 (1999)).

[287] SCGC Request for Rehearing at 3.

[288] *Id*. at 6.

[289] *Id*.

return on equity. Rather, SCGC argues that it must be assumed that the 2004 investor would be considering investment in a pipeline that would have exclusively Period Two contracts and a Period Two all-equity capital structure. In that case, SCGC argues there would be no financial risk to be taken into account by the investor and the appropriate return on equity is 8.8 percent. [290]

RCG

237. The Rolled-in Customer Group (RCG)[291] requests that the Commission establish Kern River's return on equity at the low end of the range of reasonableness, that is, 8.8 percent.[292] RCG asserts that the Commission erred when it established the return on equity at the median in the context of its approval of a 100 percent equity capital structure.

238. RCG argues that the only change between the determination of the Period One return on equity and the Period Two return on equity is Kern River's shift to a 100 percent equity capital structure. Therefore, the Commission should have adjusted the Period Two return on equity down to the low end of the range. RCG rejects the Commission's reasoning in Opinion No. 486-E that the 100 percent equity capital structure would come on line gradually and would be viewed as part of a composite equity subject to generic business risks. RCG says such reasoning does not justify use of the median return on equity since it ignores the unique characteristic of Period Two - the 100 percent equity capital structure.[293]

239. Like BP and SCGC, RCG also faults the Commission for considering investor expectations based on the "composite" equity of Period One and Period Two and Kern River's generic business risks. Raising arguments similar to those of SCGC, RCG believes any discussion of Period One and the fact the Period One contracts extend through 2015 has no relevance. RCG argues that if the

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[290] *Id*. at 6-7.

[291] RCG consists of Area Energy LLC, Anadarko E&P Company, Anadarko Petroleum Corporation, Chevron U.S.A. Inc. (on its own behalf and on the behalf of Nevada Cogeneration Associates #1 and #2), Shell Energy North America (US), LP (formerly Coral Energy Resources LP), Occidental Energy Marketing Inc., and SWEPI LP (formerly Shell Rocky Mountain Production LLC).

[292] RCG Request for Rehearing at 1, 6. RCG represents that Southwest Gas Corporation takes no position on the appropriate return on equity for Kern River.

[293] *Id*. at 5-6.

Commission determines the capital structure based solely on Period Two, then it should only have looked to investor expectations for Period Two to set the return on equity.[294]

240. RCG further argues that the "original bargain" contemplated a change to Kern River's return on equity in Period Two and that the Commission cannot argue that the original bargain, contemplating the use of a 100 percent equity capital structure, forecloses adjustment of the return on equity. RCG cites language in Opinion No. 486-D which stated that the Commission reserved its right to reexamine Kern River's return on equity in light of the change in capital structure. Thus, the shippers and the Commission are not foreclosed by the original bargain from changing Kern River's Period Two return on equity.[295] RCG argues that Commission precedents allow for an adjustment to the return on equity where a pipeline's thick equity ratio significantly reduces its financial risk.[296]

241. RCG argues that Opinion No. 486-E dismissed Kern River's arguments related to its re-contracting risks in Period Two and thus Kern River does not face risk in Period Two. Because of this low risk, RCG states the Commission should lower Kern River's return on equity to the low end of the range.[297]

Commission Determination

242. Kern River does not contest on rehearing the finding in Opinion No. 486-E that its witness's testimony used data far beyond the 2004 test period in contravention of the Commission's directive in Opinion No. 486-D.[298] However,

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[294] *Id*. at 7.

[295] *Id*. at 8.

[296] *Id*. at 9-10.

[297] *Id*. at 10.

[298] In Opinion No. 486-E, the Commission rejected Dr. Carpenter's arguments because they were based on perceptions of events that actually occurred in 2010 and 2011, and thus were not properly before the Commission. Further, the Commission noted that Kern River's risk premium approach used data for 2010 rather than 2004. Not only was this data outside the test period, but it was also taken from a period when short term interest rates were unusually low. The Commission stated that the specifics underpinning the higher risk environment that Kern River now claims would unlikely have been visible even to the most discerning investor. Opinion No. 486-E, 136 FERC ¶ 61,045 at P 200.

Kern River argues that its witness's testimony should be accepted because its ability to attract capital for Period Two is a unique issue and thus evidence outside the test period should be allowed.

243. As stated in Opinion No. 486-E and previous opinions, 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 upon the 2004 test year data used in this section 4 rate case."[299] Further, the Commission ordered that any testimony supporting any adjustment above or below the median must also be based on 2004 test period information.[300] Hence, there could have been no confusion on Kern River's part as to the appropriate scope of any testimony to be submitted on return on equity, and Kern River does not dispute that its witness's testimony is outside the test period.

244. Kern River argues that its ability to attract equity capital in Period Two is an issue unique to the transition. The Commission permitted the parties in this proceeding to consider the issue whether Kern River's return on equity should be adjusted from the median 11.55 return on equity approved for Period One, because the August 1992 Order in the optional expedited certificate stated the Commission's concern "that in the latter years of the projects, the rate of return on equity being authorized here may not be appropriate as the overall rate of return."[301] That concern arose because of the clarification the Commission granted in the August 1992 order that at the end of Period One Kern River would have a 100 percent equity capital structure. Thus, the Commission's intent in the August 1992 Order was to reserve the right to reexamine whether Kern River's return on equity should be reduced because of the reduced risk of a 100 percent capital structure.

245. Kern River seeks, instead, an increase in its return on equity based on evidence concerning various market changes since the 2004 test period, which is asserts increase the risk that Period One shippers will not recontract for service during Period Two. However, as discussed in detail above in section II (E) of this order concerning rate design volumes, the risk that shippers will not renew expiring contracts is not a circumstance unique to the transition from Period One to Period Two and does not justify consideration of post-test period market

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

[300] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 191; Opinion No. 486-D, 133 FERC ¶ 61,162 at P 197.

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

changes. The Period One shippers' option not to renew their contracts at the end of Period One is no different from any other situation in which a shipper's contract expires.

246. Kern River's protestations concerning the uniqueness of the return on equity issue simply reflect its continuing attempts to carve out exceptions to the test period approach the Commission has decided must govern this proceeding. Those arguments have been fully considered and rejected by the Commission in Opinion No. 486-E and previous orders in this proceeding.

247. We reject Kern River's claims that investors would not have understood the effect of levelization. Informed investors would have been aware that the original bargain contemplated a 100 percent equity capital structure for Kern River in Period Two. They would also have known the commencement date of Period Two and would have factored that "time lag" into their assessment of Kern River's business and financial risks. Contrary to Kern River's assertions, reasonable investors in 2004 would have and should have assumed that the Commission would continue to affirm its orders.

248. Kern River faults Opinion No. 486-E for failing to address the risks associated with its Period Two contracts in the consideration of the return on equity. Kern River states that Paragraph 200 of Opinion No. 486-E rejected any contemporaneous risk assessment as "not properly before" the Commission.[302]

249. The Commission in that language was referring to Kern River's arguments on exceptions that its re-contracting risks in Period Two (also raised in support of Kern River's proposed 95 percent billing determinants) supported a return on equity of 13.00 percent. The Commission stated that Kern River's arguments concerning its contracting risks were based on perceptions of events that actually occurred in 2010 and 2011 and were therefore not properly before the Commission. However, Kern River is mistaken in asserting that we ignored the contracting risks. Opinion No. 486-E noted that investors would have discerned that Kern River faced some future risk in re-contracting due to pipeline competition, but also reasoned that it was most unlikely that an investor would have foreseen pipeline expansion on the scale of the Ruby and REX pipelines.

250. More importantly, the risk in re-contracting is the primary reason we have not required Kern River's return on equity to be adjusted down from the median for purposes of determining Period Two rates. The Commission concluded that on the basis of the 2004 record, there was no suggestion that investors would perceive the risks associated with re-contracting as so high that a premium return would be

[302] Kern River Request for Rehearing at 24.

required for Period Two or that the gas supply environment would present reasonable concerns that Kern River's gas supplies would be displaced.[303] However, at the same time, there was sufficient risk of unexpected market developments during the seven year period before the first set of Period One contracts expired that could affect Kern River's ability to retain shippers when those contracts expired, that investors would perceive such reduced risks as to justify a reduction in Kern River's return on equity.

251. While their precise arguments vary, BP, RCG, and SCGC all essentially argue that the Commission should determine the appropriate return on equity for Kern River solely on the basis of financial risk. All parties assert that since Kern River has a 100 percent equity ratio for Period Two, its financial risk is virtually eliminated, and therefore its return on equity should be at the low end of the range, which is 8.8 percent.

252. BP, RCG, and SCGC assert that the Commission erred because it did not evaluate Kern River's financial risk based on the 100 percent capital structure it approved in Opinion No. 486-E, but rather on a "composite" structure, which reflected debt and equity components from both Period One and Period Two. BP states that the Commission thus used different capital structures to set rates and to evaluate risk. These parties state that had the Commission properly used the Period Two 100 percent equity capital structure in determining Kern River's return on equity as of 2004, it would have recognized that Kern River had no financial risk. BP and RCG argue that the Commission also found that Kern River had average business risk. In those circumstances, these parties argue that the return on equity must be set at the low end of the range.

253. All parties base their arguments on statements in Opinion No. 486-E that stated that the Period Two capital structure would evolve gradually. In particular, the parties focus on the following two statements:

> It is true that investors would recognize that 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.[304]

and

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[303] Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 202-203.

[304] *Id*. P 204.

> 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.[305]

254. These parties misinterpret these statements. The cited language in no way indicates that the Commission ignored Kern River's 100 percent equity capital structure or was unaware of the company's lessened financial risk in assessing what the appropriate return on equity was for Kern River. Rather, this language forms part of the Commission's discussion of what informed investors might have perceived in 2004 about Kern River's business risk.

255. BP, RCG, and SCGC emphasize that given the 100 percent equity capital structure, Kern River has virtually no financial risk. As we said in Opinion No. 486-E, any adjustments to the 11.55 percent median return on equity must be based on information that investors had available to them in 2004. Such investors would consider information relevant to both financial and business risks. It goes without saying that a 100 percent equity structure would be perceived by informed investors to lessen substantially a company's financial risk. The existence of such a capital structure for Period Two, however, would have been only one of the many factors that investors would have had available for consideration in 2004. Moreover, while the existence of a 100 percent equity capital structure undeniably reduces financial risk, such a capital structure does not in and of itself eliminate all business risk.

256. What investors would have perceived relative to Kern River's business risk must be taken into consideration, and the remainder of the language in the referenced paragraphs from Opinion No. 486-E discusses this very point. The first excerpt cited by the parties is taken from the Commission's discussion in Opinion No. 486-E 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. The Commission's comments were made in the context of evaluating what 2004 investors would have perceived concerning Kern River's business risk, and not as any indication that the Commission was using a different capital structure to determine the appropriate return on equity. Opinion No. 486-E further stated that:

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[305] *Id*. P 205.

> 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.[306]

257. Thus, the existence of the 100 percent equity capital structure cannot be construed to completely off-set the potential business risks Kern River might face. As described in Opinion No. 486-E, the Commission determined that an informed investor trying to assess business risk would have known that Kern River had a good business profile, *e.g*., its consistently strong throughput level, superior credit rating, and successful expansion history.[307] At the same time, however, they would have perceived that Kern River would still face some business risk. Investors would likely not have assumed that an investment in Kern River was completely risk-free.

258. The Commission reasoned that investors would still focus on such issues as Kern River's ongoing credit risks and other routine business risks. Thus, the Commission correctly concluded that the fact that the financial and business risks attributable to the some 88 percent of Period One contracts that would remain in effect through the end of 2015 would trend the required return on equity toward the median and not toward the lower end of the range. The parties have adduced no evidence on rehearing that would cause us to reverse our evaluation of Kern River's business risk as likely seen by 2004 investors.

259. Accordingly, we reject the contentions of BP, RCG, and SCGC that the Commission used the wrong "composite" capital structure to determine the appropriate return on equity. At bottom, these parties' arguments, which emphasize Kern River's 100 percent equity capital structure to the exclusion of

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[306] *Id*. P 204.

[307] *Id*. P 202.

any other considerations, ask the Commission to determine Kern River's return on equity solely on the basis of its financial risk. Acceptance of these parties' arguments would ignore the role of business risk in assessing the appropriate return on equity.

260. Contrary to SCGC's belief, the fact that 88 percent of Period One contracts remain in effect until 2015 is not irrelevant. An informed investor would have recognized that this represented some degree of business risk for Kern River in Period Two depending on whether the company could maintain its currently successful track record of re-signing its customers.

261. RCG's arguments concerning the effect of the original bargain are not relevant. The original bargain goes to the fact that Kern River will have a 100 percent equity capital structure in Period Two. Kern River's return on equity is a separate matter. There is no disagreement that Opinion No. 486-D allowed the participants to address at the hearing the question of whether Kern River's return on equity should to be adjusted from the median for Period Two. That language in Opinion No. 486-D, however, was not a ruling that the Commission intended to adjust the existing 11.55 percent return on equity after the hearing.

262. We reject BP's argument that Kern River's return on equity must be adjusted due to its anomalous equity ratio. The numerous Commission orders which BP cites regarding the relationship between the thickness of a company's equity ratio and its return on equity are not persuasive in the context of this proceeding.[308] First, all of the Commission orders BP cites are in the context of rate proceedings for pipelines certificated under the traditional requirements of section 7 of the NGA. Significantly, Kern River was created pursuant to the terms of the Commission's optional certificate regulations. As stated in Opinion No. 486-E, 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. In this context, Kern River's capital structure is unique, and comparisons to other pipelines' equity ratios do not render it any more or less anomalous. The August 1992 Order in the optional expedited certificate

[308] Like BP, RCG argued that under earlier Commission precedents the return on equity has been reduced where a thick equity ratio significantly reduced financial risk. RCG also cited two cases where the Commission adjusted the return on equity upward because of the pipeline's extremely high debt ratio. These orders only show that the Commission has previously adjusted the return on equity upward in the appropriate circumstances. RCG has adduced no additional facts relevant to Kern River's circumstances which would bear upon the determination of return on equity in this proceeding.

proceeding granted Kern River's request for clarification that it will have a 100 percent equity capital structure during Period Two.[309]

263. Opinion No. 486-E carefully assessed the information investors would have had available to them in 2004, relative to both financial and business risk. On balance, the Commission concluded that there was no compelling evidence that a 2004 investor would have perceived that Kern River would be a pipeline of greater or lower than average risk. Thus, no adjustment to the median return of 11.55 was warranted. On rehearing, no party has presented any facts or arguments which would cause us to reverse or modify this finding. As has been noted throughout this opinion, parties may always pursue adjustments to Kern River's return on equity in another rate proceeding.

H. Rehearing Issues Addressed in Conjunction with Kern River's Filing to Comply with Opinion No. 486-E

264. Opinion No. 486-E required 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. Opinion No. 486-E also provided that the tariff records setting forth the Period Two rates would be effective on October 1, 2011 and the tariff records setting forth the eligibility conditions would be effective on September 1, 2011. The Commission adopted this schedule so that it could complete its NGA section 5 action in this proceeding in time for the Original System shippers with 10-year Period One contracts expiring on September 30, 2011 to obtain Period Two contracts pursuant to the just and reasonable tariff provisions required by Opinion No. 486-E.

265. As required by Opinion No. 486-E, Kern River submitted its compliance filing on August 5, 2011. Parties filed their protests and comments on that filing on or before August 17, 2011. Parties filed their requests for rehearing of Opinion No. 486-E between August 19 and 22, 2011. In some cases, parties argued the same issues in both their protests to Kern River's compliance filing and their requests for rehearing of Opinion No. 486-E.

266. On August 29, 2011, the Commission issued an order, accepting Kern River's proposed tariff records concerning the Period Two eligibility requirements, to be effective September 1, 2011, subject to conditions.[310] The Commission directed Kern River to eliminate its proposed rate matrices and also accepted Kern River's proposal requiring Original System shippers whose Period

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

[310] August 29, 2011 Order, 136 FERC ¶ 61,141.

One service agreements expire on September 30, 2011 to submit a binding request for transportation service no later than September 1, 2011. In addition, the Commission found that any shipper with an expiring Self-Contained Contract may choose to receive Period Two service on September 1, 2011, subject to the terms and conditions of service contained within its existing Self-Contained Contract and the corresponding rate schedule.

267. On September 30, 2011 the Commission issued an order accepting the tariff record setting forth the Period Two rates. In addition the Commission also rejected a September 1, 2011, motion by NVE, which had a Period One contract expiring on September 30, 2011. NVE requested that the Commission find that its September 1, 2011 Notice of Intent to Contract constituted a valid election of Period Two service on Kern River's Original System. In its September 30, 2011 order the Commission found that the rate disparities between 10-Year and 15-Year shippers on the Original System who execute 10-year contracts for Period Two were justified.[311] The Commission also found that despite arguments to the contrary, Kern River properly used actual 2004 test period billing determinants in calculating 15-Year 2003 Expansion shippers' rates.[312] Lastly, the Commission found that NVE had not properly notified Kern River of its intent to re-contract. The Commission stated that the Commission's orders in this proceeding required 10-year Original System shippers with contracts expiring on September 30, 2011 to make a binding and non-conditional commitment to take Period Two service by September 1, 2011 and that NVE had not met this requirement.[313]

268. As discussed below, in addressing the protests to Kern River's compliance filing, the August and September 2011 Orders addressed most of the contentions the parties made with respect to the same issues in their requests for rehearing of Opinion No. 486-E. To the extent the contentions raised in the rehearing requests have not been addressed in the August and September 2011 Orders, we address them below.

1. <u>Period Two Service Term Choices</u>

269. In Opinion No. 486-E, the Commission held that Kern River may require Period One shippers "to enter into Period Two contracts with terms of either 10 or 15 years at the shipper's election…."[314] In its August 5, 2011 Period Two

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[311] September 30, 2011 Order, 136 FERC ¶ 61,241 at P 27.

[312] *Id*. P 47

[313] *Id*. P 70.

[314] Opinion No.486-E, 133 FERC ¶ 61,045 at P 25.

compliance filing, Kern River proposed to require that all eligible shippers with Period One contracts expiring on the same date must have the same 10 or 15-year contract term for Period Two service. Kern River also proposed that if the shippers in the customer class do not agree to the same term, the term for all shippers in that customer class would be 10 years by default.

270. In their rehearing requests, RCG and SCGC request that the Commission clarify that Opinion No. 486-E does not authorize Kern River to require all shippers whose Period One contracts expire on the same date to have the same Period Two contract term. SCGC argues that Opinion No. 486-E is clear that the Commission intended that each eligible Period One Kern River shipper should have the option of taking Period Two service for either 10 years or 15 years at the shipper's discretion regardless of any election made by other shippers. However, SCGC requests rehearing if the Commission believes that Kern River's filing is consistent with Opinion No. 486-E.

271. The RCG also requests that the Commission clarify that the 10‑or 15‑year contract term for Period Two rates is at the election of the individual shipper, and that shippers are not required to coordinate on the terms of their Period Two contracts. The RCG maintains that in several places in Opinion No. 486‑E, the Commission referred to the right of the individual shipper to opt for its own contract term for Period Two rates.[315]

272. Kern River argues, on rehearing, that Opinion No. 486-E states that it affirms the ALJ's decision to adopt Kern River's proposal to give eligible Period One shippers the option to select a contract duration of 10 or 15 years for service at Period Two rates.[316] Therefore, Kern River requests that the Commission clarify that its ruling approves its proposal to require all shippers whose Period One contracts expire on the same date to have the same Period Two contract term in this case. In the alternative, Kern River seeks rehearing.

273. Kern River asserts that its testimony established that uniformity in the length of Period Two contracts among shipper groups was essential to prevent administrative complications. Kern River argues that permitting shippers an opportunity to select their own contract duration leads to increased administrative burdens due to the need to create and maintain multiple levelization models to

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[315] RCG Request for Rehearing at pp. 12-13 (citing, Opinion No. 486-E, 133 FERC ¶ 61,045 at PP 25, 71.

[316] Kern River Request for Clarification or Rehearing at p. 64, (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 60.

track the regulatory and book depreciation amounts for each shipper over the differing time periods.[317] Kern River asserts that to accommodate shippers' requests for more flexibility it agreed to offer 10- and 15-year contracts, subject to certain conditions.

274. Kern River states that while offering both 10-and 15-year contracts it would require the selected contract term for each shipper to coincide with the levelization period for each shipper class in order to limit the problems that would arise from maintaining multiple levelization models. Kern River states that this is consistent with its contracting practices throughout Period One.[318] Kern River points out that many of its shippers also recognize that it would be discriminatory for shippers within the same customer class to have different Period Two contract terms.[319]

275. Kern River argues that the ALJ agreed with Kern River, finding that "[t]he Period Two contracts for each Shipper group should be of uniform duration."[320] Therefore, Kern River argues that the ALJ adopted Kern River's proposal to limit the contract duration option to each step-down shipper group and it states that no shipper took exception to this ruling. Kern River asserts that while Opinion No. 486-E states that it affirms the ALJ in this respect, it does not clearly state that the proposal it adopted provides for a uniform contract duration among each shipper group.

Commission Determination

276. The Commission fully considered the parties' contentions on this issue in its August 29, 2011 order, addressing Kern River's proposal in its filing to comply with Opinion No. 486-E to require all shippers whose Period One contracts expire on the same date to have the same Period Two contract term. [321] In that order, the Commission rejected Kern River's proposal, finding that each shipper should be able to elect its own contract term without regard to the contract term elections of other shippers. Accordingly, the Commission grants SCGC and RCG's request, and denies Kern River's request, for clarification or rehearing of Opinion No. 486-E on this issue, for the reasons given in the August 29, 2011 Order.

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[317] *Id.* (citing, Ex. No. KR-P2-3 at 9:11-10:5).

[318] *Id.* P 65 (citing, Kern River Initial Brief at 27).

[319] *Id.* (citing, RCG Initial Brief at 18-19).

[320] *Id.* (citing, ID 135 FERC 63,003 at P 1052).

[321] August 29, 2011 Order, 136 FERC ¶ 61,141 at PP 31-34.

2. **Procedures for Original System 10 Year Shippers to Obtain Period Two Contracts**

277. In Opinion No. 486-E, the Commission held that Original System shippers with Period One contracts expiring on September 30, 2011, must make a binding commitment whether to execute a Period Two contract on or before September 1, 2011. The Commission explained:

> This order is resolving all issues concerning the Period Two rates for those shippers and 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 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.[322]

The deadline adopted by Opinion No. 486-E allowed the 10-year Original System shippers nearly a month to review Kern River's August 5, 2011 compliance filing before making a binding contractual commitment to take service during Period Two.

278. In its request for rehearing of Opinion No. 486-E, BP argues that the September 1, 2011 deadline does not give the 10-year Original System shippers sufficient time to make the commercial arrangements with their customers that would underpin any contractual commitment by the 10-year shippers to purchase Period Two capacity from Kern River for 10 or 15 years. BP contends that a natural gas marketer, such as BP, may want to enter into contracts with buyers of

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[322] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 84. In addition, the Commission also stated at Ordering Paragraph (D) of Opinion 486-E that:

> (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.

the gas that the marketer would transport on Kern River during Period Two before the marketer commits to purchase capacity from Kern River for a 10 or 15-year period. BP asserts that, in order to make such commercial arrangements with its customers, it needs to know the Period Two transportation rate that it would pay Kern River. However, BP asserts, despite the need for shippers to know the Period Two rate when determining whether to re-contract, Kern River has made a series of non-complying filings incorporating features that were inconsistent with Commission rulings, including use of a 95 percent load factor and inclusion of post-test period compressor plant. Therefore, until its August 5, 2011 compliance filing, Kern River had not filed Period Two rates even remotely in compliance with the Commission's rulings. BP states that the compressed 25-day period between Kern River's compliance filing and the September 1, 2011 deadline leaves shippers selling gas off of Kern River little time to secure commitments from their customers of 10 or 15 years duration.

279. Moreover, BP contends that Kern River's compliance filing proposal to require all shippers with contracts expiring on the same date to have the same Period Two contract term means that the 10-Year Original System shippers may not know the duration of their Period Two contracts until after the September 1, 2011 deadline for them to make binding contractual commitments to purchase capacity from Kern River. That is because, if the two 10-year Original System shippers request different contract durations,[323] Kern River proposes to give them until September 5, 2011 to reach agreement with one another over the conflicting lengths of their designated contract renewals, or it would impose a default 10-year Period Two contract term.

280. BP requests that the Commission mitigate the effects of the short notice period given the length of the required contract commitments by the affected shippers. BP suggests that the Commission should permit that, after such notices have been provided (on September 1, 2011) and after Kern River has had an opportunity to market any such capacity not designated for renewal in such notices, any such capacity not subscribed as of 60 days after the Commission accepts a compliance filing by Kern River without any further modifications to the tariff sheets and Period Two rates, may be subscribed at the Period Two rate by the entity that originally held the capacity in Period One. BP argues that this suggestion would permit Kern River an opportunity to sell the capacity not subscribed pursuant to the notice on September 1, 2011 at a rate above the Period Two rate, while also affording gas merchants such as BP a realistic opportunity to

[323] BP and Nevada Power Company d/b/a NV Energy (NVE) are the only Original System shippers with 10-year Period One contracts.

make plans covering 10 or 15 years worth of commercial arrangements with their customers.

281. In its August 29, 2011 order on Kern River's compliance filing, the Commission accepted Kern River's proposed GT&C section 30.2(d), requiring Original System shippers whose Period One service agreements expire on September 30, 2011 to "submit a binding request for [Period Two] transportation service no later than September 1, 2011."[324] The Commission found that tariff provision to be consistent with the holding in Opinion No. 486-E that it is just and reasonable to require the Original System shippers "to make a binding and non-conditional 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."[325] However, the Commission rejected Kern River's proposal to require all shippers with contracts expiring on the same date to have the same 10 or 15-year contract term during Period Two.[326]

Commission Determination

282. The Commission denies BP's request for rehearing concerning the September 1, 2011 deadline for Original System 10-year shippers to make a binding contractual commitment whether to execute contracts for Period Two service.

283. NVE raised a similar issue in its September 1, 2011 motion regarding its September 1, 2011 Notice of Intent to Contract for Period Two rates. In that notice, NVE stated that it intended to contract for Period Two service under Kern River's Rate Schedule MO-1 at Period Two rates, subject to NVE obtaining an order from the Commission which would make several findings to remove the uncertainty faced by NVE in regard to its rate choices.[327] In its motion, NVE requested that the Commission issue an order giving it the option to discontinue Period Two service if the Commission approves any modifications to the non-rate terms of Rate Schedule MO-1. NVE argued that it should not be forced to make an unconditional, binding commitment to take service during Period Two by September 1, 2011, because the Commission had not yet made a final determination that it will be able to take that service under Rate Schedule MO-1

[324] *Kern River Gas Transmission Co.*, 136 FERC ¶ 61,141 at P 48.

[325] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 84.

[326] *Kern River Gas Transmission Co.*, 136 FERC ¶ 61,141 at PP 31-34.

[327] September 30, 2011 Order, 136 FERC ¶ 61,241 at P 54.

for the entire term of Period Two, instead of being required to shift to service under Rate Schedule KRF-1.

284. The Commission denied NVE's motion. The Commission stated that, as a special accommodation to the two 10-year shippers on Kern River's Original System due to the unique circumstances of this proceeding, Opinion No. 486-E had permitted those shippers not to make a binding commitment to take service in Period Two until September 1, 2011, only one month before their Period One contracts expired. The Commission recognized that some uncertainties remained, including the fact that rehearing of Opinion No. 486-E's holdings concerning contract duration and the level of the Period Two rates was pending. However, the Commission found that NVE was in no different situation from any other shipper required to recommit to capacity while a section 4 or 5 proceeding was pending in which changes are sought in the terms and conditions of the service at issue. The Commission also pointed out that, even at a point where all uncertainty as to the outcome of a currently pending proceeding is removed because all Commission determinations in a proceeding are final, there is no guarantee that the pipeline may not exercise its rights under the NGA to file a new section 4 proposal to change the rates, terms and conditions.[328]

285. The same reasoning applies with respect to BP's rehearing request concerning the September 1, 2011 deadline. While the Commission understands BP's desire for certainty concerning the rates that it would pay over the 10 or 15-year term of a Period Two contract, such rate certainty is not possible under the statutory scheme established by the NGA, absent a settlement or negotiated rate agreement between Kern River and BP. If a shipper's contract expires while a section 4 or section 5 rate case is pending, it is inevitable that the shipper must decide whether to renew its contract without knowing the final outcome of the pending case. Moreover, during the term of any renewed contract, the NGA would permit the pipeline's rates to be changed in a new section 4 or 5 proceeding initiated after the shipper renews its contract.

286. In addition, while Kern River did not submit a compliance filing containing Period Two rates consistent with all the Commission's rulings in Opinion No. 486-E until August 5, 2011, the prior proceedings in this case gave BP similar notice of the possible outcomes of the Period Two rate proceeding as any shipper has when it must decide whether to renew a contract while a rate proceeding is pending.[329] On February 1, 2010, over a year and a half before the September 1,

[328] *Id*. PP 73-74.

[329] BP's concerns about Kern River's proposal to require all shippers with contracts expiring on the same date to have the same 10 or 15-year contract term

2011 deadline, Kern River submitted a compliance filing with its proposed levelized Period Two rates. As in most rate proceedings, Kern River's shippers protested various aspects of Kern River's proposal. As required by the Commission, Kern River provided the shippers sufficient information that they could estimate the rate impact of the resolution of each issue.[330] On November 18, 2010, over 10 months before the September 1, 2011 deadline, the Commission issued Opinion No. 486-D, clarifying the Period Two rate issues to be addressed at hearing.[331] Among other things, the Commission held that Kern River could use a 100 percent capital structure for its Period Two rates but rejected Kern River's proposed inflation adjustment for its O&M and A&G costs. The remaining issues to be addressed at the hearing -- including compressor costs, rate design volumes, rate levelization methodology, and whether the return on equity should be adjusted above or below that established for Period Two -- were not significantly different from the type of issues that may be pending in a rate case when a shipper's contract expires and it must decide whether to renew the contract. On April 14, 2011, three and a half months before the September 1, 2011 deadline, the ALJ issued his Initial Decision with his recommended resolution of the issues set for hearing.[332] On July 21, 2011, the Commission issued Opinion No. 486-E, affirming all of the ALJ's holdings concerning the calculation of Kern River's Period Two rates.

287. Given these circumstances, we think it reasonable to expect that, well before Kern River's August 5, 2011 filing to comply with Opinion No. 486-E, BP would be carefully analyzing whether to contract for service during Period Two depending upon the possible outcomes of the Period Two hearing. Particularly after the ALJ issued his initial decision in April 2011, BP could have considered whether it should contract for Period Two service, if the Commission affirmed the ALJ's rate determinations, as the Commission ultimately did. Opinion No. 486-E

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during Period Two have been addressed by the August 29, 2011 Order's rejection of that proposal.

[330] Among other things, the Commission required Kern River to provide the shippers with the computer program used to calculate its levelized rates. On May 2, 2007 the Commission found that it was appropriate for the parties to have the computer model on which Kern River based its compliance filings so that they may properly evaluate such filings. *Kern River Gas Transmission Co.*, 119 FERC ¶ 61,106 (2007).

[331] Opinion No. 486-D, 133 FERC ¶ 61,162 at PP 193-200.

[332] ID, 135 FERC ¶ 63,003.

made a special accommodation for BP, by permitting it not to make a binding commitment to take service in Period Two until September 1, 2011, only one month before their Period One contracts expired. The Commission concludes that BP has not shown the Commission should also provide BP a special, additional right, after September 1, 2011, to obtain capacity at Period Two rates once the Commission has issued a final order approving Kern River's Period Two rates.

288. Accordingly, the Commission declines to grant rehearing on this issue.

3. Procedures for Other Shippers to Obtain Period Two Contracts

289. In section 30.2(b) of the *pro forma* tariff sheets Kern River included in its February 1, 2010 filing to comply with Opinion No. 486-C, Kern River proposed to require that "An Eligible 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." Kern River subsequently agreed that this provision would not apply to the 10-year Original System shippers discussed in the preceding section.

290. In his initial decision, the ALJ found that Kern River's proposed 12-month notice period for shippers (other than the 10-year Original System shippers) was just and reasonable.[333] The ALJ stated that he found "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."[334] Mr. Dushinske testified:

> Given the competitive conditions anticipated in Period Two, and the expected difficulties in marketing firm capacity in the event Period One shippers decline to take service in Period Two, I believe that the 12-month notice requirement is reasonable. The process of soliciting interest in unsubscribed capacity, negotiating potential agreements or other service parameters, and consummating sales – particularly in the buyer's market likely to prevail – is likely to require significant

[333] ID, 135 FERC ¶ 63,003 at P 1071. 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.

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

> time and resources. The recommended 12-month period represents a reasonable estimate that balances the shippers' interests and those of Kern River."[335]

The ALJ also stated that the issue of whether shippers should be required to provide 12-months notice "may be less important as Kern River's counsel provided clarification at the hearing that a good faith filing at the 12-month mark will merely provide a placeholder for shippers."[336]

291. Morgan Stanley and Kern River filed exceptions to the ALJ's finding. Morgan Stanley argued that the ALJ erred by failing to address arguments that a one-year notice period is unnecessary. Morgan Stanley argued 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 asserted that because Kern River had 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.[337]

292. Kern River opposed Morgan Stanley's exception, arguing that the ALJ had found the 12-month notice period to be necessary based on the testimony of Kern River's witness Mr. Dushinske. Kern River also argued that Morgan Stanley failed to provide any justification for its preferred notice period of six months and

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[335] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 79, (citing, Kern River Brief op. Ex. at 47 (citing Ex. No. KR-P2-9 at 17-18)).

[336] 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).

[337] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 77 (citing, Morgan Stanley Brief on Ex. at P 21).

that Morgan Stanley merely asserted 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.

293. In its exception to the ALJ's decision, Kern River also argued that the Commission should clarify that, while the 12-month notice affirmed by the ID will provide information to Kern River concerning eligible shippers' intent to contract for Period Two service at the step-down rates, it is not a commitment by the shipper to contract for Period Two service and therefore it creates no obligation for Kern River to reserve the capacity.[338] Parties such as RCG opposed this exception and argued that a shipper's notice of intent to contract for Period Two should create an obligation for Kern River to reserve capacity for that shipper; otherwise Period One shippers could be denied their rights to any Period Two service.

294. In Opinion No. 486-E, the Commission affirmed the ALJ on this issue and found 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 impose on shippers wishing to invoke their right of first refusal in order to renew expiring contracts.[339]

295. Opinion No. 486-E did not expressly address Kern River's exception. In its August 5, 2011 compliance filing Kern River submitted proposed Section 30.2(a) of its GT& C to state: "[a]n Eligible Shipper must submit to Transporter a binding request for Period Two transportation service not less than twelve (12) months

[338] Kern River Brief on Exceptions at pp. 30-31.

[339] Opinion No. 486-E, 136 FERC ¶ 61,045 at P 82.

prior to the expiration of the primary term of its Period One transportation service agreement . . ..”[340]

296. SCGC, RCG, and Calpine protested Kern River’s proposal in its August 5, 2011 compliance filing to require shippers to make binding requests for Period Two service 12 months before the expiration of their contracts. In their requests for rehearing of Opinion No. 486-E, SCGC and RCG also requested that the Commission clarify that Kern River’s proposal violates Opinion No. 486-E.

297. In both its protest and rehearing request, SCGC contends that Opinion No. 486-E intended that a shipper’s 12-month notice be a placeholder, not a binding commitment to take service during Period Two. SCGC states that Opinion No. 486-E recognized that the ALJ not only found that “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 [is] just and reasonable,”[341] but also that Kern River’s clarification at hearing that a good faith filing at the 12-month mark will merely provide a placeholder for

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[340] Kern River Gas Transmission Company FERC Tariff § 30.2(a) (Third Revised Vol. No. 1-Issued Sept. 6, 2011) proposes that:

> Eligible Shipper must submit to Transporter a binding request for Period Two transportation service not less than twelve (12) months prior to the expiration of the primary term of its Period One transportation service agreement; provided, however, that Eligible Shippers, whose Period One transportation service agreements expire April 30, 2012, must submit a binding request for transportation service no later than November 1, 2011, and Eligible Shippers with only seasonal service must submit a binding request for transportation service at the same time as the other Eligible Shippers in their respective Shipper group. Such request shall be signed by an authorized representative of the Shipper, shall state the requested DMDQ and shall specify either a 10- or 15-year term for Eligible Shipper’s Period Two TSA. If the requested DMDQ is less than Eligible Shipper’s then-current DMDQ, the request shall state the associated reduction to the Shipper’s primary receipt and delivery point entitlements. Eligible Shipper’s Period Two TSA must be for the same calendar months as its Period One transportation service.

[341] SCGC Rehearing Request at p. 12 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 76. SCGC points out that the ALJ found that “that a good faith filing at the 12 month mark will merely provide a placeholder for Shippers.” (citing, *Kern River Gas Transmission Co.*, 135 FERC ¶ 63,003 at P 1071 (2011))).

Shippers, would mitigate their concerns about being required to give such notice 12-month's in advance.[342]

298. Therefore, SCGC argues that Kern River's proposal in its compliance filing to make the 12-month notice binding (rather than a mere placeholder) is inconsistent with Opinion No. 486-E. SCGC maintains that the record on this matter is clear in that, as the ALJ found, Kern River's counsel expressly stated that a customer's notice to take service would not be binding.

299. SCGC asserts that the ALJ found that this meant "that a good faith filing at the 12 month mark will merely provide a placeholder for Shippers."[343] SCGC states that Kern River did not begin its retreat from the position quoted by its counsel until it filed its Brief on Exceptions regarding the Initial Decision which is too late to change course on this important point.

300. SCGC also maintains that Kern River's proposal in its August 5, 2011 filing to require that a customer's 12-month notice be binding is inconsistent with Section 30.4 of its August 5, 2011 proposal where it proposed that the "Transporter will file for acceptance tariff sheets setting forth the applicable reservation rate(s) for Period Two no less than six months prior to the effective date of each Period Two rate." SCGC argues that if the shipper must give a 12-month binding notice, under the tariff provisions as proposed by Kern River the shipper would be required to bind itself to service at a rate which would not be known until six months later. SCGC states that this is an unfair consequence of requiring a shipper's notice to be binding. In its rehearing request, SCGC seeks rehearing of Opinion No. 486-E, if the Commission intended to permit the 12-month notice to be binding.

301. The RCG also asserts that in Opinion No. 486-E, the Commission found that 12 months' notice was reasonable expressly because the ALJ found "that Kern River's clarification at the hearing that a good faith filing at the 12-month mark will merely provide a placeholder for Shippers mitigated their concerns about being required to give such notice 12 months in advance."[344]

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[342] *Id.*

[343] *Id*. (citing, *Kern River Gas Transmission Co.*, 135 FERC ¶ 63,003 at P 1071).

[344] RCG Rehearing Request at p.14 (citing, Opinion No. 486-E, 136 FERC 61,045 at P 76).

302. The RCG requests the Commission to clarify that for all other shipper classes, except the 10-year Rolled-In Shipper class, the 12 months' notice to Kern River for Period Two rates is considered a non-binding notice, *i.e*., the notice reflects intent and the shipper retains the option to execute a contract or not after notice is provided.

303. The RCG maintain that a non-binding notice to Kern River is appropriate because Kern River has the authority to change its Period Two rates, through a NGA section 4 filing at any point, and, therefore, the rates and terms and conditions of Period Two service may not be known at the time of the notice. RCG argues that these shippers must be given the option to determine whether to execute a service agreement for all, or a portion of, their capacity for Period Two, much the same as the Commission permits in the context of the Right of First Refusal (ROFR).

304. In its protest to Kern River's August 5, 2011 filing to comply with Opinion 486-E, RCG notes that Kern River set forth a 12-month binding notice in Section 30.2(d) of its proposed GT&C. The RCG states that it does not object to 12 months for notice, but does object to the requirement that the 12-month notice be binding. The RCG again points out that the Commission in Opinion No. 486-E determined that the 12-months' notice period was reasonable expressly because it was merely a placeholder and that this mitigated the concerns of the shippers regarding giving notice 12 months in advance of the end of their primary term. The RCG argues that the ALJ and Opinion No. 486-E's approval of a 12 month notice was expressly conditioned on the non-binding nature of the notice expressed by Kern River. The RCG argues that it is unjust and unreasonable to approve a 12-month notice absent such mitigation.

305. Calpine also protested the August 5, 2011 compliance filing on this issue and states that Kern River's 12-month binding notice requirement contradicts earlier representations that such a notice period was merely a placeholder and not binding. Therefore, Calpine argues that this 12-month binding notice fails to comply with Opinion No. 486-E.[345] In its protest, BP asserts that Kern River proposes to file its proposed Period Two rate no less than six months prior to the effective date of such rates. BP argues that given the 12-month notice period Kern

[345] Both Calpine and SCGC argue that this 12-month notice requirement is also unreasonable in combination with Kern River's proposal to require the shippers to nominate their Period Two contract length as a group. However, the Commission need not consider such arguments because the Commission rejected this group nomination provision proposal in its August 29, 2011 Order. August 29, 2011 Order, 136 FERC ¶ 61,141 at PP 31-34 (2011).

River proposed notice period would require shippers to make irrevocable commitments for a full 10 or 15 years prior to seeing the updated rates.

306. On August 24, 2011 Kern River filed an Answer to these protests.[346] Kern River argues that Opinion No 486-E found the "one year notice period is appropriate for all Period One shippers other than those with contracts expiring on September 30, 2011."[347] Kern River argues that Opinion No. 486-E expressly provides for binding notice by the 10-year Original System shippers whose contracts expired on September 30, 2011, and indicates no intention that the 12-month notice required of other shipper groups should differ in this respect.[348]

307. Further, Kern River asserts that if a shipper submitted a *non*-binding notice and that shipper then failed to execute a contract for service in Period Two, Kern River would be left with unsold capacity and limited time to resell. Therefore, Kern River asserts that a binding notice provides shippers with rate certainty when they select between 10-year and 15-year contract terms and Kern River with a reasonable understanding of its future service commitments.

308. Kern River also asserts that basic contract law requires that the subject notice be binding on the shipper as well as Kern River. Kern River argues that a shipper's notice that it will elect service at the Period Two rate constitutes an acceptance of Kern River's offer to provide service at the end of Period One. Kern River reasons that once the shipper has accepted Kern River's offer, a contract is formed and therefore, the shipper's notice is binding, both as to the shipper and to Kern River, obligating each to perform by entering into a contract for firm transportation service at the applicable Period Two rate.

309. Kern River argues the instant 12-month binding notice period reasonably balances the shippers' interests and those of Kern River."[349] Kern River asserts that this balance is reached because the 12-month notice is close enough to the

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[346] Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2012), prohibits answers to protests or answers unless otherwise permitted by the decisional authority. We will accept Kern River's answer because it will assist in the disposition of the issues raised by the protesting parties.

[347] Kern River Answer at p. 8 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 84, 82).

[348] *Id*. (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 84).

[349] *Id*. at p. 9 (citing, Ex. No. KR-P2-9 at 18).

start of Period Two that the shipper can fairly evaluate its future needs and market conditions, yet also recognizes that Kern River must go through the re-marketing of any unsubscribed capacity.

310. In its September 6, 2011 Answer to motions for clarification of Opinion No. 486-E, Kern River states that RCG seeks clarification that the 12-month notice required of eligible shippers seeking Period Two service is a "non-binding… placeholder" that reflects intent, but leaves the shipper free of any obligation to execute a Period Two contract after such notice is provided. Kern River asserts that such a clarification is sought by RCG to provide it with an option to contract for Period Two capacity in a manner that results in it accessing such capacity without risk, cost, or obligation, while imposing upon Kern River a requirement to hold such capacity in reserve in case RCG's constituent shippers ultimately elect to subscribe for service at Period Two rates.

311. Kern River argues that this issue has been ruled upon by the Commission because Opinion No. 486-E expressly provides for binding notice by the 10-year Original System shippers, and indicates no intention that the 12-month notice required of other shipper groups should differ in this respect.[350]

312. Further, Kern River states that RCG's request is impractical because under such an interpretation a shipper could submit a non-binding notice, only to later decline to contract for service in Period Two. This would leave Kern River with unsold capacity and little or no time to attempt to remarket such capacity. Kern River states that such a clarification would reserve for shippers unreasonable contracting flexibility, while ignoring the competing interests of Kern River and the significant time and resources likely to be required for soliciting interest in, and negotiating potential agreements for, any unsubscribed Period Two capacity.

313. Kern River also argues that it is entitled to a degree of contracting certainty because the Commission has determined that Period Two rates must be designed on 100 percent load factor billing determinants. Kern River argues that such a finding places the risk of re-marketing unsubscribed risk on Kern River. Kern River states that such risk has already been realized upon it in the form of the failure of both of the 10-year, Original System shippers to provide the binding commitment to service at Period Two rates.[351]

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[350] Kern River September 6, 2011 Answer at p.8 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 84.

[351] *Id*. at p. 8.

314. Lastly, in the August 29, 2011 Order on Kern River's August 5, 2011 compliance filing, the Commission stated that it was still considering the protests to Kern River's proposal to require shippers to make a binding request for Period Two service 12 months before the expiration of their contracts. Therefore, the Commission stated that it would address that issue in a subsequent order.[352]

Commission Determination

315. The Commission has reexamined the issue of when shippers other than the 10-year Original System shippers must make a binding commitment to take service during Period Two, in light of all the pleadings filed on this issue. Upon reconsideration, the Commission finds that it is just and reasonable for Kern River to require such shippers to make a binding commitment to take service during Period Two 12 months before the expiration of their Period One contracts.

316. In Opinion No. 486-E, the Commission affirmed the ALJ's findings both that Kern River's testimony in support of its proposed 12-month notice period was "very probative" and that the 12-month notice would be only a "placeholder." However, treating the 12-month notice as only a "placeholder," with no binding effect on the shipper, is inconsistent with Kern River's testimony in support of the 12-month notice period. In that testimony, Kern River sought a 12-month period after "Period One shippers decline to take service in Period Two"[353] in which to market the resulting unsubscribed capacity. Mr. Dushinske explained that the 12-month period was necessary because the "process of soliciting interest in unsubscribed capacity, negotiating potential agreements or other service parameters, and consummating sales – particularly in the buyer's market likely to prevail – is likely to require significant time and resources."[354] However, if the 12-month notice is only a placeholder, a shipper would be free to give Kern River notice 12 months before its contract expires that it intended to take service in Period Two and then at some later date decline to take service. That would deprive Kern River of the 12-month period to remarket the subject capacity before the Period One shipper's contract expires, which Kern River testified it needed and which the ALJ found to be reasonable.

317. In its exceptions to the initial decision, Kern River proposed to address this problem by requesting that the Commission clarify that Kern River is under no obligation to reserve Period Two capacity for a Period One shipper until that

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[352] August 29, 2011 Order, 136 FERC ¶ 61,141 at P 50.

[353] Ex. No. KR-P2-9 at 17.

[354] *Id.*

shipper makes a binding commitment to take service during Period Two. Thus, if a Period One shipper does not submit a binding commitment 12 months in advance, Kern River could immediately start marketing the unsubscribed capacity without the Period One shipper having any prior claim on the capacity beyond the end of Period One, thereby providing the 12-month remarketing period supported by Mr. Dushinske's testimony. Opinion No. 486-E did not address this exception by Kern River.

318. Without requesting rehearing or clarification of Opinion No. 486-E's rulings on the 12-month notice issue, Kern River proposed in its August 5, 2011 compliance filing to require that Period One shippers, other than the 10-year Original System shippers, submit a binding request for Period Two transportation service not less than twelve months before the expiration of their contracts. While we agree with the shippers that this proposal was not authorized by Opinion No. 486-E, we are, on our own motion, reconsidering Opinion No. 486-E's ruling on the 12-month notice issue. Upon reconsideration, we find Kern River's proposal in its compliance filing to be just and reasonable, and we accordingly accept that proposal.

319. In this section 5 proceeding, we have the burden to show that the replacement tariff provisions we require Kern River to implement are just and reasonable. While shipper parties argue that they should not be required to make a binding commitment 12-months before the initiation of their new Period Two contracts, and Kern River previously countered by arguing that it need not reserve capacity based upon a non-binding notice, it is clear that there must be some deadline by which Period One shippers must present Kern River with a binding notice of an intent to take Period Two capacity and Kern River must reserve such capacity for the shipper.

320. Currently, Kern River has proposed that that deadline be twelve months before the expiration of the shippers' Period One contracts. The shippers have not provided any specific alternative to Kern River's proposal other than an argument that Opinion No. 486-E did not provide for a binding notice date. However, in the Commission's view, Kern River may reasonably require a 12-month binding notice in order to give it time to permit Kern River to solicit interest in unsubscribed capacity, and negotiate agreements for any capacity not taken by shippers eligible for Period Two capacity. As previously described, the ALJ found Kern River's testimony that it needed 12 months notice for this purpose to be "very probative." In addition, the Commission has previously approved a pipeline's proposal to require shippers to provide 12 months notice in order to renew a long-term firm contract under an evergreen clause.[355] Moreover, in the

[355] *Nat'l Fuel Gas Supply Corp.*, 85 FERC ¶ 61,126, at 61,470 (1998).

circumstances of this case, the 12-month notice requirement reasonably gives Kern River time to consider whether to file a new section 4 rate case to address cost underrecovery concerns if a significant number of shippers decide not to elect Period Two service.

321. The Commission is not persuaded by the shippers' contention that the 12-month notice period could unfairly require them to make a binding commitment to take service before they know what Kern River's rates will be. It is, of course, true that Kern River could file a section 4 rate case to change its rates after the 12-month deadline. However, when shippers are making contracting decisions they are always faced with the risk that the pipeline may exercise its statutory rights under NGA section 4 to propose rate increases. Indeed, it is not uncommon for proposed changes in a pipeline's rates pursuant to sections 4 or 5 to be pending when a shipper's contract for that service expires. If the Commission were to permit shippers to postpone making binding contractual commitments to continue to take a service until such issues are finally resolved, it would seriously interfere with the re-contracting process.

322. Similarly, several shipper parties argue that because Kern River is required to file tariff sheets containing its proposed Period Two rate six months before the beginning of Period Two shippers will be required to commit to new contracts six months before Kern River files its Period Two rates. However, as can be seen by reference to Kern River's Tariff,[356] the Period Two rates are already contained in

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[356] Section 30.4 of Kern River's tariff provides:

> Except for the rates to be effective October 1, 2011, Transporter will file for acceptance tariff sheets setting forth the applicable reservation rate(s) for Period Two no less than six months prior to the effective date of each Period Two rate. The Period Two rates will be consistent with the applicable rates shown on Sheet Nos. 299E and 299F for rolled-in rate shippers (original and 2002 Expansion shippers), and on Sheet No. 299G for 2003 Expansion shippers; provided, however, (a) Transporter may adjust such rates as necessary to reflect leap years and any current or future surcharges. (b) In the case of rolled-in rates, such rates will be dependent upon and shall be adjusted by Transporter according to the contract term selected by all Eligible Shippers in the rolled-in rate group.
> (c) Transporter may change the Period Two rates from time to time in accordance with the Natural Gas Act. (d) The Period Two rates shall be adjusted to reflect changes applicable to rolled-in shippers when Transporter implements Period Three rates, in order to reflect reductions in revenue credits that result from the ending of Period

Kern River's tariff, and the six month filing prior to the start of Period Two is to make specified adjustments to the Period Two rates including adjustments which result from whether shippers have decided to retain service in Period Two.[357] In fact, the six month rate filing cannot be accurately calculated by Kern River until after shippers have made binding contractual decisions regarding Period Two service. Therefore, the shippers' binding contractual decisions must be made sufficiently before the 6-month limited section 4 filing to allow Kern River to make the necessary rate calculations.

323. Accordingly, the Commission accepts Kern River's proposal to require shippers wishing to obtain Period Two capacity to provide Kern River with 12 months binding notice of their intent to contract. Kern River, for its part, will then reserve any necessary capacity for a shipper wishing to execute a contract for Period Two capacity or if an eligible shipper informs Kern River that its does not wish to contract for Period Two capacity this will permit adequate time for Kern River to initiate recontracting procedures so that it might resell the capacity.

4. Period Two Rate Disparity

324. BP argues that Opinion No. 486-E erred by failing to recognize that the Period Two rates proposed by Kern River are unjust, unreasonable and unduly discriminatory with respect to the Original System 10 Year Shippers. BP asserts that these rates are excessive and that they require the Original System 10 Year Shippers to pay higher rates than the Original System 15 Year Shippers for Period Two contracts of the same duration. BP argues that the Period Two rates do not fairly reflect the fact that both the Original System 10 Year and 15 Year Shippers are to pay 30 percent of plant during Period Two as part of the original risk sharing agreement.

325. BP asserts that the recalculation of Period Two rates is more properly and efficiently addressed in the compliance phase of this proceeding. However, BP states that out of an abundance of caution and to ensure that the issue is timely addressed by the Commission, BP also seeks rehearing on this issue.

Commission Determination

326. On September 30, 2011, the Commission accepted filings by Kern River to comply with Opinion No. 486-E concerning the proper derivation of Period Two

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Two TSAs.

[357] *See* section III of this order, for a description of the required adjustments.

rates.[358] There, the Commission addressed all concerns related to Kern River's Period Two rates. In particular, the Commission addressed arguments by BP that the Period Two rates proposed by Kern River were unjust, unreasonable and unduly discriminatory with respect to the Original System 10Year Shippers on the same grounds as it argues here. However, the Commission addressed all such concerns in detail and found that Kern River's Period Two rates complied with the holdings of Opinion No. 486-E and were just and reasonable.[359] Accordingly, the Commission accepted the tariff records to be effective October 1, 2011.

327. No party requested rehearing of the Commission's September 30, 2011 order. Accordingly the Commission finds that it has adequately addressed the concern raised by BP on this matter.

5. Clarification of Period Two Billing Determinants

328. On rehearing of Opinion No. 486-E, Kern River maintains that the Commission confirmed the ALJ's finding that the Period Two billing determinants should be determined by the "use of 95 percent rather than a 100 percent load factor."[360] However, Kern River points out that in Opinion No. 486-E, the Commission also directs Kern River to set Period Two billing determinants using "the same actual 2004 test period billing determinants as used to design Kern River's Period One rate."[361]

329. Kern River asserts that these two directives are not interchangeable. Kern River explains that its 2004 test period billing determinants, as reflected in its January 29, 2010 compliance filing, include a volumetric adjustment to recognize the discounted rates under two of Kern River's 2003 Expansion contracts. Kern River asserts that both of these contracts expire prior to the commencement of Period Two for the affected shipper group, the 10-year 2003 Expansion shippers. Kern River asserts that in designing Period Two rates for purposes of its August 5, 2011 compliance filing, Kern River used 100 percent load factor billing determinants, rather than the actual 2004 test period billing determinants. Kern River states that this calculation comports with the ALJ's specific finding, that the "100% Load Factor is a just and reasonable level to be used for cost allocation and

[358] September 30, 2011 Order, 136 FERC ¶ 61,241.

[359] *Id*. P 18.

[360] Kern River Rehearing Request at 20 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at PP 1, 163, 189).

[361] *Id*. at 20 (citing, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 166).

rate design of the Period Two rates."[362] Kern River also asserts that this method properly eliminates the discount adjustment associated with the two contracts that expire before Period Two.

330. Accordingly, Kern River requests clarification regarding the billing determinants to be used in calculating Period Two rates and, specifically, seeks confirmation that the use of 100 percent load factor design volumes complies with the requirements of Opinion No. 486-E.

<u>Commission Determination</u>

331. On September 30, 2011, the Commission issued an order reviewing the rates Kern River proposed in its August 5, 2011 filing to comply with Opinion No 486-E.[363] The Commission held that Kern River had properly used actual end of 2004 test period reservation billing determinants to design the Period Two 2003 Expansion rates, without any adjustment. The Commission stated that the Period Two rates for that expansion are well below the discounted rates in effect during the 2004 test period. Therefore, it is reasonable to project, based on the 2004 test period data, that Kern River will not discount its Period Two rates for the 2003 Expansion. As a result, it is just and reasonable for Kern River to design its Period Two rates for the 2003 Expansion based upon the full level of both the 10-Year and the 15-Year 2003 Expansion shippers' billing determinants. In fact, given the projection that Kern River will not discount its Period Two rates, any discount adjustment would be unjust and unreasonable. The September 30, 2011 order concluded that Kern River had properly utilized the appropriate test period date in calculating its Period Two rates for all shippers.[364] No party requested rehearing of this determination.

332. Accordingly, the Commission need not further clarify the billing determinants Kern River must use in calculating Period Two rates.

[362] *Id*. at 20 (citing, ID, 135 FERC ¶ 63,033 at P 1030).

[363] September 30, 2011 Order, 136 FERC ¶ 61,241.

[364] *Id*. P 51.

I. Rehearing Issues Resolved by Settlement

333. RCG argues that the Commission erred when it stated that its finding on the sanctity of the Self-Contained Contracts was without prejudice to Kern River filing to eliminate the rate schedules with the Self-Contained Contracts.[365]

334. Kern River argues that the Commission erred in authorizing shippers under self- contained Contracts to extend or roll-over those agreements to continue service at Period Two Rates.[366] Kern River also argues that the Commission's refusal to permit Kern River to require Rate Schedule KRF-1 Service Agreements for all Period Two service constitutes error.[367] Kern River asserts that the Commission's decision that its shippers may take Period Two service under Self-Contained contracts cannot be reconciled with its ruling that Shippers must elect Period Two service for terms of 10 or 15 Years.[368] Kern River argues that the Commission's findings supporting the rejection of Rate Schedule KRF-1 are insufficient to support such a finding.[369] Kern River maintains that the Commission's finding that the Self-Contained contracts cannot materially deviate from the Rate Schedule KRF-1 *Pro Forma* Service Agreement constitutes error.[370] Lastly, Kern River argues that the Commission's speculation that requiring Rate Schedule KRF-1 service for all Period Two Shippers may unnecessarily discriminate constitutes error and is legally insufficient to support such a ruling.[371]

Commission Determination

335. On February 1, 2012, the Commission issued an order approving an uncontested Settlement that resolved issues related to Kern River's Self Contained contracts and the implementation of its Rate Schedule KRF-1.[372] As set

[365] RCG Request for Rehearing at pp. 11-12.

[366] Kern River Rehearing Request at p. 35.

[367] *Id*. p. 39.

[368] *Id*. p. 43.

[369] *Id*. p. 45.

[370] *Id*. p. 49.

[371] *Id*. p. 48.

[372] *Kern River Gas Transmission Co.*,138 FERC ¶ 61,078.

forth above, this settlement provides that the Self-Contained contracts under which several of the Kern River Shippers currently take service will be closed to new shippers and then eliminated. The settlement provides that all of Kern River's firm mainline shippers will be served under Rate Schedule KRF-1. The Settlement provides that all of the shippers will execute restatements of their currently effective contracts and that shippers may retain certain nonconforming provisions of their self contained contracts as they transition to Rate Schedule KRF-1 service as described in the Settlement. If a Settling Shipper elects Period Two service, the new Period Two contracts executed by such shipper will contain the subject nonconforming provisions. Moreover, the settlement also resolves roll-over rights of the Settling parties.

336. The Settlement provides that the Settling Shippers' claims in Docket Nos. RP11-2328-000, RP04-274-000, RP04-274-023, RP04-274-029, RP11-2031-000, RP11-2031-001, RP11-2356-000, and RP11-2356-001, related to the following shall be deemed withdrawn: (i) requests that Kern River be ordered to provide service under any of the Self Contained Rate Schedules and (ii) requests that Kern River be ordered to provide service under any contract provisions that are inconsistent with the Rate Schedule KRF-1 *pro forma* agreement, except as expressly provided in the Settlement.

337. Opinion No. 486-E was issued in Docket No. RP04-274-023. Therefore, this Opinion is subject to the Settlement. Because RCG and Kern River are settling parties and the Settlement resolves the use of Self-Contained contracts and Rate Schedule KRF-1 for all settling parties on a forward basis the Commission need not address the issues designated above or otherwise resolved by the Settlement.

III. <u>Request for Rehearing of August 29, 2011 Order</u>

338. On August 29, 2011, the Commission issued an order accepting the August 5, 2011, tariff records filed by Kern River to comply with Order No. 486-E.[373] The August 29, 2011 Order, addressed tariff records related to Period Two shipper eligibility requirements, reserving certain rate issues for further discussion. Accordingly, the August 29, 2011 Order accepted certain tariff sheets filed by Kern River subject to conditions to be effective September 1, 2011. Of import here, the August 29, 2011 Order acted upon tariff provisions included by Kern River to address the effect of the 2002 Expansion which was rolled into the

[373] August 29, 2011 Order, *Kern River Gas Transmission Co.*, 136 FERC ¶ 61,141 (2011).

original system rates because this roll-in lowered rates for both the original system shippers and the 2002 Expansion shippers.

339. Kern River asserted that the rate reduction benefit provided to the Original System shippers was based on crediting a portion of the revenues collected from the 2002 Expansion Project shippers to the Original System shippers. Kern River asserted that, as the 2002 Expansion Project shippers step down to Period Two rates, their respective costs of service decline, and thus the revenues received from the 2002 Expansion service go down. As a result, the credit to the Original System will decline when the lower, Period Two rates for the 2002 Expansion Project shippers become effective, and, Kern River asserted, the Period Two rates of the Original System shippers should correspondingly increase. Accordingly, Kern River proposed a rate matrix of sixteen possible rate scenarios, which could result from the various contract duration elections.[374]

340. Several parties opposed Kern River's proposed rate matrix, arguing that Kern River should not be permitted to make any modifications to the $ .0345 per dth rate reduction for the Original System shippers approved in Opinion No. 486-A for Period One. They argued that Kern River must maintain that rate reduction throughout Period Two, unless Kern River files a general NGA section 4 rate case. The Commission rejects this contention.

341. In its August 29, 2011 Order, the Commission reasoned that in Opinion No. 486-D, it held that the starting point for calculating Period Two rates must be the cost of service as determined for Period One based upon the 2004 test period. In Opinion No. 486-D, the Commission discussed its general policy that it 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.[375] However, the Commission also noted that it was appropriate to make adjustments "where there are circumstances unique to the transition from Period One to Period Two that justify an adjustment

[374] Kern River stated that these rate scenarios arise because the revenues Kern River will collect during Period Two from the 2002 Expansion shippers depend upon whether such shippers elect 10-year or 15-year Period Two contracts, the exact level of the reduced credit to the Original System shippers and corresponding increase in their Period Two rates cannot be known until after the 2002 Expansion shippers have made their contract duration elections for Period Two. *Id*. P 39.

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

to the cost of service underlying the Period One rates."[376] Therefore, in the August 29, 2011 order the Commission determined that the reduction in revenue collected from the 2002 Expansion Project shippers when they step down to Period Two rates was a circumstance that was unique to the transition from Period One to Period Two.[377] The Commission found that it was appropriate to reduce the revenue credit reflected in the Original System shippers' Period Two rates when the 2002 Expansion Project shippers commence Period Two service.

342. The Commission then turned to Kern River's proposed rate matrix and found that the proposal was premised upon a requirement that all shippers whose contracts expired on the same date must enter into Period Two contracts of the same duration. The Commission rejected this requirement and as a result determined that it was not practical for Kern River to include a rate matrix showing all the potential adjustments to the Original System shippers' contracts as of the effective dates of the 2002 Expansion Project shippers' Period Two contracts. The Commission directed Kern River to eliminate the rate matrices and to file revised tariff records to include the 10-year and 15-year Period Two rates for each group of Original System and 2002 Expansion Project shippers upon the commencement of Period Two for that shipper group, in the same manner as section 30.2(b) sets forth the Period Two rates of the different groups of 2003 Expansion shippers. The Commission also stated that Kern River would be permitted to include in its tariff a mechanism under which it may file for approval an appropriate adjustment to the Period Two rates of the Original System shippers within a reasonable time after each group of 2002 Expansion Project shippers have made their contract duration election. The Commission found that such mechanism may take the form of a limited section 4 filing consistent with this discussion.

343. On September 28, 2011, RCG filed a request for rehearing of the Commission's August 29, 2011 Order. In essence, RCG argues that the Commission erred in determining that Kern River may modify Period One or Two rolled-in rates on an ongoing basis to take account of the elimination of the rolled-in rate credit associated with the 2002 Expansion (when the 2002 Expansion shippers' contracts terminate), without filing a general section 4 rate case.

344. RCG argues that the Commission's action in permitting future rate changes under a limited section 4 tariff filing rather than a general section 4 rate case, to address a single cost changing event, i.e., the elimination of the roll-in credit when

[376] Opinion No. 486-D, 135 FERC ¶ 61,162 at P 194.

[377] August 29, 2011 Order, 136 FERC ¶ 61,141 at P 41.

the 2002 Expansion contracts terminate was in error. RCG argues that the Commission's policy is to avoid piecemeal modification of a pipeline's rates.[378] RCG argues that the Commission's action violates its policies without explanation except for stating that the elimination of the 2002 Expansion roll-in credit is a circumstance unique to the transition from Period One to Period Two.

345. RCG asserts that the Commission also erred in finding that the elimination of the roll-in credit was "a circumstance unique to the transition from Period One to Period Two." RCG points out that the elimination of the roll-in credit can occur at the termination of the Period One 2002 Expansion contract, regardless of whether the Period One 2002 Expansion shipper determines to contract for Period Two. RCG asserts that all Period One shippers may not choose to contract for Period Two or may choose to contract for less than the required time period at non-Period Two rates. RCG argues that the point is that there is no mandatory linkage between 2002 Expansion contracts and Period Two contracts. RCG asserts that the fact that it is possible for 2002 Expansion shippers to not contract for Period Two proves that the termination of 2002 Expansion contracts has no relationship to Period Two at all.

346. RCG asserts that this termination of contracts is unrelated to any transition to Period Two. Moreover, it asserts that this situation is the same as that faced by all pipelines when contracts expire and billing determinants are lost. RCG argues that in such a situation the Commission has never allowed a pipeline to file a limited section 4 case to reflect only the loss of revenues associated with the loss of billing determinants.

347. RCG argues that the Commission erred in failing to follow its precedent in two regards. First, RCG argues that the Commission's failure to follow its precedent against piecemeal litigation as set forth above is unreasoned decision-making. By allowing Kern River to change rates with only a limited section 4 filing, RCG argues that this leaves Kern River's original system shippers assured

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[378] RCG Request for Rehearing at p.3 (citing, *CNG Transmission Corp*., 63 FERC ¶ 61,330, at 63,192 (1993); *see also Trunkline Gas Co*., 94 FERC ¶ 61,381, at 62,422 (2001) (the Commission's "policy is to avoid piecemeal modification of a pipeline rates in limited section 4 filings, because there are many variables addressed in a general rate proceeding that can change overall rate levels"); *Midwestern Gas Transmission Co*., 57 FERC ¶ 61,073, at 61,269, n.3 (1991) ("trackers are not permitted because it could result in overcompensation due to tracking only one element of the cost of service while not taking into account offsetting decreases in other costs.")).

of a rate increase, with no ability to argue for offsetting costs justifying a rate decrease.

348. Second, RCG argues that Kern River placed before the ALJ the same Period Two transition theory relied upon by the Commission in the August 29, 2011 Order. RCG asserts that the ALJ rejected that argument, finding that the issue was beyond the scope of the hearing. RCG then argues that if the ALJ found that this argument constituted a transitional issue, then there would have been no basis for his finding that the issue was beyond the scope of the hearing. RCG argues that the Commission failed to acknowledge in the August 29, 2011 order that in Opinion No. 486-E, the Commission approved the Initial Decision on all findings, including the ALJ's finding that this issue was beyond the scope of the proceeding.[379]

Commission Determination

349. The Commission rejects RCG's assertion that the reduction in revenue collected from the 2002 Expansion Project shippers when they step down to Period Two rates is a circumstance that was not unique to the transition from Period One to Period Two. The reduction in revenue related to these contracts when the shippers step down to Period Two rates is related to a transition from Period One rates to Period Two rates and as such must be permitted to be adjusted for in a limited section 4 proceeding. A portion of the of the revenues collected from the 2002 Expansion Project shippers is used to provide a rate reduction benefit to the Original System shippers. As the 2002 Expansion Project shippers qualify for the step down Period Two rates, the cost of service for each 2002 Expansion Project shipper declines and the revenues received from the 2002 Expansion service go down. Therefore, the credit or rate reduction benefit to the Original System declines as the lower, Period Two rates for the 2002 Expansion Project shippers become effective. Because the credit declines as the 2002 Expansion Project shippers enter into their lower Period Two rates, this requires that the Period Two rates for the Original System shippers recover increased costs which would require that the Period Two rates for such Original Shippers should be increased as a direct result of the transition of the 2002 Expansion Project shippers from Period One rates to Period Two rates.

350. RCG also maintains that because these shippers may not re-contract for Period Two rates this situation is not unique to the transition from Period One rates to Period Two rates and that this proves that the termination of 2002

[379] RCG Request for Rehearing at p.5 (citing, *Kern River Gas Transmission Co.*, Opinion No. 486-E, 136 FERC ¶ 61,045 at P 1).

Expansion contracts has no relationship to Period Two at all. As stated above, the Commission finds that such a circumstance is related to the transition from Period One rates.

351. First, this limited adjustment is only related to 2002 10- and 15-year expansion shippers. As Kern River points out in its August 5, 2011 compliance filing, WPX Energy Marketing, LLC (formerly Williams Gas Marketing, Inc.) is the only 10-year 2002 Expansion Shipper on Kern River's system and its original contract for Period One rates expires on May 1, 2012.[380] Second, 15-year 2002 Expansion Shippers on Kern River's system all maintain contracts that will expire on April 30, 2017. Therefore, the expiration of all the contracts at issue here takes place on the same date and the effect on Kern River's rate of all the expired contracts from the original 2002 Expansion could be examined in a single proceeding, if necessary.

352. RCG's assertion that a 2002 Expansion Shipper may not re-contract for a Period Two rate does not prove that the termination of 2002 Expansion contracts bear no relationship to Period Two. However, this argument provides an opportunity for the Commission to clarify the effect that a 2002 Expansion Project Shipper that does not re-contract for Period Two rates may have upon a limited section 4 proceeding.

353. The Commission recognizes the need to adjust the Period Two rates to accommodate the re-contracting of 2002 Expansion Project Period One shippers. Further, such a filing should adjust the credits to the Original Shippers in a manner consistent with the effect the transitioning Period One 2002 Expansion Shippers have on the cost recovered by the Period Two rates. However, in the instance where a 2002 Expansion Project shipper does not re-contract, a limited section 4 rate case need not automatically make a pre-determined adjustment for the credits involved. For instance, the Commission did not and does not pre-grant the removal of all credits for contracts that are not renewed. As RCG points out, the Commission does not permit a pipeline to file a limited section 4 case simply because contracts have expired and billing determinants are lost. Rather, in such a

[380] Kern River has already adjusted the rates to allow for the expiration of the 2002 10-year expansion shipper on its system. On December 1, 2011, Kern River filed tariff records in Docket No. RP12-201-000 to revise its Period Two rates to reflect the expiration of the 10-year, 2002 Expansion Project rolled-in shipper's contract on April 30, 2012 and the replacement Period Two 15-year contract becoming effective May 1, 2012. On January 11, 2012 these tariff records rates were accepted, subject to the outcome of Docket No. RP12-2356-000.

case, the Commission must examine the effect of the loss of the contract billing determinants and revenues on the Period Two rate credits if and when such a case presents itself. Accordingly, given this clarification, the Commission denies rehearing on this issue.

IV. Compliance with August 29, 2011 Order

354. On August 5, 2011, Kern River filed revised tariff records to comply with Opinion No. 486-E.[381] These tariff records reflect (1) eligibility requirements for shippers to pay Period Two rates, to be effective September 1, 2011, and (2) rates for Period Two shipper groups and tariff records for Period Two rates, to be effective October 1, 2011.

355. On August 29, 2011, the Commission issued an order[382] accepting the August 5, 2011 tariff records, addressing Period Two shipper eligibility requirements, subject to conditions to be effective September 1, 2011. The Commission required Kern River to (1) remove language requiring shippers to elect as a group Period Two service and (2) remove the Period Two rate matrix showing possible Period Two rate scenarios and (3) file revised tariff language that will permit Kern River to make the appropriate rate adjustment after each individual shipper in each 10 or 15-year rate class has made its individual choice concerning the rate term it desires in Period Two. The Commission stated that Kern River may revise its tariff records to include the 10-year and 15-year Period Two rates for each group of Original System and 2002 Expansion Project shippers upon the commencement of Period Two for that shipper group, in the same manner as section 30.2(b) of Kern River's tariff sets forth the Period Two rates for different groups of 2003 Expansion shippers.

356. On September 6, 2011, Kern River filed revised tariff records[383] in compliance with the Commission's August 29, 2011 Order. Kern River has

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[381] 136 FERC ¶ 61,045.

[382] August 29, 2011 Order, 136 FERC ¶ 61,141.

[383] Kern River Gas Transmission Company, FERC NGA Gas Tariff, Gas Tariff, Sheet No. 299, Contracting for Service Subject to P2 (Step-Down) Rates, 1.1.0; Sheet No. 299A, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0; Sheet No. 299B, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0; Sheet No. 299C, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0; Sheet No. 299D, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0; Sheet No. 299E, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0; Sheet No. 299F, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0; Sheet No. 299G, Contracting for Service Subject to P2 (Step-Down) Rates,

submitted revised language in its GT&C to: (1) remove language requiring shippers to elect as a group Period Two service; (2) delete the Period Two rate matrix, and; (3) permit Kern River to make an appropriate rate adjustment after each individual shipper in each 10- or 15-year rate class has made its individual choice concerning the rate term it desires in Period Two. This revised tariff language provides that Kern River will make a limited section NGA section 4 filing to establish the applicable reservation rates for Period Two service not less than six months prior to the effective date of each Period Two rate. Kern River has also made other necessary clarifications as a result of the August 29, 2011 Order such as adding a missing contract commencement date and other minor editorial changes.

<u>Public Notice, Intervention, and Responsive Pleadings</u>

357. Public notice of the filing was issued on September 7, 2011. Protests were due as provided in section 154.210 of the Commission's regulations (18 C.F.R. § 154.210 (2012)). Protests and or comments were filed by Questar Gas Company (Questar), Southern California Gas Company (SoCal), and Calpine Energy Services (Calpine).

358. On September 19, 2011, Questar filed a protest to Kern River's September 6, 2011 filing to comply with the August 29, 2011 Order. Questar states that it is currently a 15-year, 2003 Expansion Shipper on Kern River pursuant to a transportation agreement dated June 6, 2001, with a primary term ending on April 30, 2018, (Contract No. 1715). Questar states that this contract entitles it to firm transportation service on both a year-round and seasonal-service basis. Questar seeks clarification that the proposed language of Kern River's tariff will require it to submit to Kern River a binding request for Period Two transportation service not less than twelve months prior to the expiration of the primary term of Contract No. 1715, meaning submission of such binding request to Kern River no later than April 30, 2017.

359. Secondly, Questar states that Kern River proposes that eligible shippers with only seasonal service must submit a binding request for transportation service at the same time as the other Eligible Shippers in their respective Shipper group. Questar states that its contract provides for both seasonal and year round service. Questar states that it is unclear what Kern River means by requiring that shippers with "with only seasonal service. . ." who then are required to submit a "binding request for service at the same time as other Eligible Shippers in their respective Shipper Group." Accordingly, Questar requests that the portion of Section 30.2(a)

0.1.0.

setting forth binding service request submissions for "only seasonal service" shippers be clarified as not applying to its contract and that the only binding request submission for Period Two service applicable to Contract No. 1715 is the twelve-month request described in the preceding paragraph.

360. In its September 26, 2011 Answer to Questar and other commenters on its September 6, 2011 compliance filing, Kern River states it concurs with Questar that its proposed Section 30.2(a) which requires that, in order to be eligible for Period Two rates, a shipper must submit a binding request for service not less than 12 months prior to the expiration of the primary term, will include Questar's Contract No. 1715.

Commission Determination

361. The Commission finds that Kern River has complied with the August 29, 2011 Order. Therefore, the revised tariff records filed on September 6, 2011, in this proceeding as listed in Appendix A are accepted effective September 1, 2011, subject to the condition discussed below.

362. Kern River has correctly revised the tariff language in its GT&C to: (1) permit individual shippers the option to choose either a ten year or a fifteen year contract term; (2) delete the Period Two rate matrix; (3) permit Kern River to make a limited section 4 filing to establish the applicable reservation rates for Period Two service and permit Kern River to make appropriate rate adjustments after each individual shipper has elected its contract term for Period Two service.

363. The Commission finds that section 30.3(e)(3) of Kern River's revised GT&C inadvertently left out the word "Period" in the following language, "Eligible Shippers that are part of the Rolled-in Original System shipper group whose Period One transportation service agreements end April 30, 2018, and that enter into [Period] Two TSAs that commence May 1, 2018." Therefore, Kern River is required to file a revised section 30.3(e)(3) of its GT&C within fifteen days of the date this order to correct this oversight.

364. The Commission finds that the issues raised by the protesters in this proceeding have subsequently been discussed at length in the Commission's September 30, 2011 order (regarding the derivation of Period Two rates and intent to contract for Period Two rates),[384] the Commission's February 1, 2012 Order (approving uncontested settlement regarding use of Kern River's Rate Schedule KRF-1 for Period Two rates)[385] and the instant order. The Commission need not

[384] September 30, 2011 Order, 136 FERC ¶ 61,241.

[385] *Kern River Gas Transmission Co.*, 138 FERC ¶ 61,078.

further address such issues. Accordingly, the Commission accepts the revised tariff records filed on September 6, 2011, to be effective, subject to condition, September 1, 2011.

V. Kern River's October 31, 2012 Filing

365. On October 31, 2012, Kern River filed a revised tariff record[386] in Docket No. RP13-199-000 to adjust the 10-year and 15-year Period Two rates applicable to eligible 2003 Expansion Project shippers whose transportation service agreements (TSA) expire on April 30, 2013. Kern River explains that these new rates will become available to eligible 2003 Expansion shippers when their existing 10-year Period One TSAs expire and service commences under new Period Two TSAs for either 10 or 15-year terms. Kern River requests that its proposed tariff record be made effective May 1, 2013, or at the end of any suspension period that may be imposed by the Commission.

366. Kern River submits workpapers supporting its proposed Period Two rates which were previously submitted in Kern River's August 5, 2011, filing in Docket Nos. RP04-274 and RP11-2356 and Kern River incorporates support from these filings by reference in the instant filing.

367. Pursuant to section 30.4 of its tariff, Kern River was required to submit a filing to establish the Period Two rates to be effective May 1, 2013 no less than six months prior to the effective date of the new rates. As a result, Kern River requests waiver of the Commission's notice requirement to permit the proposed tariff record to be filed more than 60 days in advance of the proposed effective date. The Commission grants waiver of its notice requirement to allow the tariff record listed in footnote No. 1 to become effective May 1, 2013.

Public Notice

368. Public notice of the filing was issued on October 31, 2012. Protests were due as provided in section 154.210 of the Commission's regulations (18 C.F.R. § 154.210 (2012)). Comments were filed by Calpine. Indicated Shippers filed a request for Commission action.[387] Kern River filed an answer to the comments of Calpine. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18

[386] Kern River Gas Transmission Company, FERC NGA Gas Tariff, Gas Tariff, Sheet No. 5A.01, Statement of Rates, 2003 Expansion, 0.0.0.

[387] Indicated Shippers include Occidental Energy Marketing, Inc., Shell Energy North America (US), L.P., Southwest Gas Corporation, and WPX Energy Marketing, LLC.

C.F.R. § 385.213(a)(2) (2012), prohibits answers to protests or answers unless otherwise permitted by the decisional authority. We will accept Kern River's answer because it will assist in the disposition of the issue raised by the protesting party.

Discussion

369. The Commission finds the instant tariff record to be just and reasonable and in conformance with the requirements of Kern River's tariff, and therefore the Commission accepts the tariff record effective May 1, 2013. Indicated Shippers request the Commission accept the instant filing subject to the outcome of the ongoing proceedings in Docket Nos. RP04-274-023 and RP11-2356-001, consistent with prior Commission orders on Kern River's Period Two rates.[388] Because the Commission has now acted on all pending requests for rehearing and compliance in these proceedings, there is no need to make acceptance of the subject tariff record subject to the outcome of these proceedings.

370. Calpine does not take issue with the Period Two rates proposed by Kern River in the October 31, 2012 filing. However, Calpine comments that its protest regarding Kern River's proposed binding 12-month notice requirement for Period Two rates remains pending in Docket Nos. RP04-274 and RP11-2356. Calpine requests that the Commission resolve this matter by rejecting the proposed binding notice requirement. Kern River requests the Commission to disregard the comments filed by Calpine because the binding notice requirement Calpine attempts to comment on in this docket was set forth in Section 30.2 of the tariff record Kern River submitted in its August 5, 2011 filing in Docket Nos. RP11-2356 and RP04-274 to comply with Opinion No. 486-E. Kern River asserts that Calpine already filed comments and protests in those dockets and cannot use this filing docket as a forum to further protest the issue.

371. As discussed above, the Commission finds that the 12-month binding notice period is just and reasonable. Accordingly, the Commission denies Calpine's request that the Commission require Kern River to revise its tariff to make the 12-month notice non-binding.

The Commission orders:

(A) The requests for rehearing or clarification of Opinion No. 486-E, the August 29, 2011 Order and the December 6, 2010 Clarification order are granted

[388] Indicated Shippers Request at p. 3 (citing, August 29, 2011 Order, 136 FERC ¶ 61,141 at P 26; *see also Kern River Gas Transmission Co.*, Docket No. RP12-201-000 (Jan. 11 2012) (delegated letter order).

and denied as discussed in the body of this order.

(B) The tariff records listed in Appendix A are accepted, effective September 1, 2011.

(C) The tariff record listed in Appendix B is accepted effective May 1, 2013.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

Appendix A

Kern River Gas Transmission Company
FERC NGA Gas Tariff
Gas Tariff
Tariff Records Effective September 1, 2011

Sheet No. 299, Contracting for Service Subject to P2 (Step-Down) Rates, 1.1.0

Sheet No. 299A, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Sheet No. 299B, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Sheet No. 299C, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Sheet No. 299D, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Sheet No. 299E, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Sheet No. 299F, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Sheet No. 299G, Contracting for Service Subject to P2 (Step-Down) Rates, 0.1.0

Appendix B

Kern River Gas Transmission Company
FERC NGA Gas Tariff
Gas Tariff
Tariff Record Effective May 1, 2013

Sheet No. 5A.01, Statement of Rates, 2003 Expansion, 0.0.0