UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

KERN RIVER GAS TRANSMISSION COMPANY	**)**	**Docket No. RP18-___-000**

STATEMENT OF
KERN RIVER GAS TRANSMISSION COMPANY
EXPLAINING WHY NO RATE ADJUSTMENT IS NECESSARY

Pursuant to the procedures set forth in the Federal Energy Regulatory Commission's ("FERC" or "Commission") Final Rule in Docket Nos. RM18-11-000, et al.[1] and the regulations promulgated therein,[2] Kern River Gas Transmission Company ("Kern River") hereby submits its Statement Explaining Why No Rate Adjustment Is Necessary, including additional information not contained in Kern River's FERC Form No. 501-G,[3] which is being filed concurrently herewith.

Kern River commends the Commission for the overall balanced approach taken, following passage of the Tax Cuts and Jobs Act ("TCJA"), to ensure pipelines rates are just and reasonable. Kern River particularly appreciates the Commission's commitment to develop an understanding of each pipeline's "unique and different circumstances." Requiring pipelines to provide appropriate data in a structured format, but inviting the pipelines, who know the data and their financial position better than anyone else, to provide pipeline specific facts and circumstances and to propose necessary adjustments to properly

[1]Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate, Order No. 849, Final Rule, 164 FERC ¶ 61,031 (2018) ("Final Rule").
[2]18 C.F.R. § 260.402.
[3] The One-time Report on Rate Effect of the TCJA is referred to interchangeably as "FERC Form No. 501-G" or "One-time Report." Kern River's FERC Form No. 501-G is reproduced herein as Exhibit "1."

accommodate their unique facts and circumstances, is an efficient and reasonable way to effectuate a new law such as the TCJA.

As shown herein, based on a consideration of all the facts and circumstances related to Kern River's rates, there is no basis for concluding that Kern River's rates are unjust and unreasonable. Accordingly, Kern River respectfully requests the Commission to find that no rate adjustment is necessary. In support hereof, Kern River states as follows:

I.
EXECUTIVE SUMMARY

When the impact of the TCJA on Kern River is reflected on the FERC Form No. 501-G, and necessary corrections are made to properly reflect Kern River's unique levelized rate structure,[4] Kern River's return on equity *after tax reform* is 12.5 percent.[5] Moreover, when the adjusted return on equity shown on the One-time Report is considered in light of the contract turn back and the revenue risk Kern River faces in its primary marketplace, no adjustment to Kern River's rates, as a result of the TCJA, is appropriate.

Historically, the vast majority of Kern River's capacity has been contracted under long-term maximum tariff rate service agreements. However, the market and contracting practices on Kern River have fundamentally changed. FERC Form No. 501-G, which reflects a snapshot of conditions on Kern River as of December 31, 2017, does not reflect the current commercial environment or the large contract turn back that occurred April 30, 2018, a magnitude of turned-back capacity never experienced by Kern River and

[4] Kern River is so fundamentally different from every other major interstate pipeline with traditional rate structures. The Commission certificated Kern River under the optional certificate regulations and authorized a levelized rate structure. *Kern River Gas Transmission Co*., 60 FERC ¶ 61,123 (1992). Adjustments to the FERC Form No. 501-G are required to accommodate Kern River's levelized rates and to account for the 2017 Alternate Period Two settlement approved by the Commission.
[5] Exhibit "2."

rare in the industry. Importantly, this contract turn back occurred even though the shippers had an option to extend their contract at a significant discount to the then current Period One rate.[6]

Demand for Kern River's capacity to transport Rocky Mountain gas to Southern California has fallen in the last several years, which has resulted in a decline in the value of Kern River's capacity. Market declines in Southern California and the strong demand for low-cost Permian Basin gas has significantly decreased demand for Rocky Mountain gas on Kern River. The most significant impact of the unprecedented soft demand came to fruition in May 2018 when a large group of shippers did not recontract their capacity because the forward prices of Kern River's capacity did not support the dramatically lower tariff rate. As of May 1, 2018, following the turn back of capacity by the 2003 15-year Expansion shippers, Kern River had 648,092 Dth/day of long-term unsubscribed capacity to California, which represented approximately 30 percent of Kern River's long-term contracted capacity.

The confluence of poor market conditions for capacity on Kern River's pipeline and expiring long-term maximum tariff rate agreements on April 30, 2018, has resulted in a materially different risk profile for Kern River in 2018 and going forward than existed in 2017. As of May 1, 2018, for the first time since the pipeline went into service in 1992, Kern River has a substantial quantity of capacity that is not subscribed under long-term firm contracts. Despite Kern River's extraordinary effort to incent long-term capacity holders to contract for Period Two service, there simply was no demand for long-term agreements at, or even close to, much lower effective tariff rates. Consequently, after the

[6] The 2003 Expansion 15-year shippers had multiple options to extend their contracts at significantly lower rates, including an option that represented a 57.2 percent discount to the Period One rate.

turn back Kern River sold most of the capacity under month-to-month index-based, volumetric agreements, which subjected Kern River revenue to the variability of market prices.[7]

This fundamental paradigm shift makes use of the FERC Form No. 2 ("Form 2") data as of December 31, 2017, an unreasonable means to project Kern River's return in 2018 and in the future. Based on the significantly increased exposure to unsubscribed capacity and daily market pricing, Kern River's ability to sustain a return close to its authorized return is highly unlikely given current market conditions. The reality is that Kern River is subject to far more revenue risk than the historical period reflected in FERC Form No. 501-G. Based on current and projected market conditions, any adjustment to Kern River's rates would be unjust and unreasonable and would prompt Kern River to file a section 4 rate case to adjust billing units to reflect the impact of turned-back capacity.

II.
BACKGROUND AND INTRODUCTION

A. <u>Tax reform impact on pipeline rates.</u>

On July 18, 2018, the Commission issued the Final Rule in response to the TCJA. The Final Rule requires interstate natural gas pipelines to file the One-time Report, which is designed to collect financial information to allow the Commission to evaluate the impact of the TCJA on such pipelines' revenue requirement. The Commission recognized in the Final Rule that some pipelines should be exempt from the requirement to file the One-time Report. In addition to clarifying that pipelines may, on a case-by-case basis, request waivers of the filing requirements, the Commission provided automatic exemptions from

[7] During 2017, the period covered by the Form 2, the index price of Kern River capacity was below the 2003 Expansion 10-year Period Two rate 85 percent of the days. Exhibit "3."

filing the One-time Report to: (1) pipelines that file an uncontested, prepackaged settlement of their rates between March 26, 2018, the date the NOPR was published in the Federal Register, and the date their One-time Report would otherwise be due and (2) pipelines whose rates are being examined in a general rate case under NGA section 4 or a rate investigation under NGA section 5 as of the deadline for filing their One-time Report.[8]

The Final Rule recognizes that those pipelines filing a One-time Report will not necessarily be required to file the prospective reductions in rates indicated by the information contained in such report. It offers four options for a pipeline to address changes to its recovery of tax costs: (1) a limited NGA section 4 filing to reduce rates to reflect the decrease in the tax rate; (2) a commitment to file a general NGA section 4 rate case in the near future; (3) a statement explaining why an adjustment to rates is not needed; or (4) no action other than filing the One-time Report.[9] The Final Rule states that if a pipeline does not choose either of the first two options, the Commission will consider, based on information in the One-time Report and other materials, "whether to issue an order to show cause under NGA section 5 requiring the pipeline either to reduce its rates to reflect the income tax reduction or explain why it should not be required to do so."[10]

B. <u>Kern River does not have a traditional rate structure.</u>

Kern River is unique among major interstate pipelines and has been from its beginning. Originally certificated in 1989 and placed in service in 1992, Kern River transports natural gas supplies from the Rocky Mountain area to its primary market in

[8] Final Rule at P 159.
[9] *Id*. at P 190.
[10] *Id.* at P 21.

Southern California where it serves gas and electric utilities and industrial customers, particularly the enhanced oil recovery and cogeneration markets in Kern County, California.[11] Kern River also has major delivery points in Utah and Nevada. Kern River was authorized to construct its facilities under the Commission's Optional Certificate procedures adopted in Order No. 436.[12] Eligibility under the Optional Certificate procedures required Kern River, as a new service provider, to provide open access transportation and required it to assume the risks of the project. In the original certificate order, the Commission authorized use of a levelized cost of service, which levelizes recovery of capital costs and operating costs, such as O&M and A&G costs, over a total of 25 years. The Commission 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 were designed to recover approximately 70 percent of Kern River's original investment, an amount equal to the portion of its invested capital funded through debt.[13] The Period Two rates were designed to recover the remaining 30 percent of Kern River's invested capital. Period Two rates were designed on 100 percent equity capital structure since the capital funded through debt was paid off with Period One rates.[14] The Commission said Period Three rates would recover operating expenses, taxes and a reasonable management fee. This unique levelized

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[11] *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077, Opinion No. 486 (2006).
[12] *Kern River Gas Transmission Company*, 50 FERC ¶ 61, 069 (1990) ("Original Certificate Order").
[13] Original Certificate Order, 50 FERC ¶ 61,144.
[14] *Opinion No. 486 P 106*. See also, *Aera Energy L.L.C.*, 789 F.3d 184 (2015), *Citing* Original Certificate Order.

structure remains in place today, although the lengths of Period One and Period Two, as well as the applicable depreciable lives, have been extended.[15] Kern River is not aware of any other major interstate pipeline that has been authorized to charge levelized rates for multiple periods.

C. <u>As of May 1, 2018, contract turn back represented approximately 30 percent of Kern River's long-term revenue.</u>

Since the pipeline went into service in 1992, it has essentially been fully contracted. Exhibit "4" shows Kern River's long-term contract capacity since 2013, following completion of Kern River's most recent expansion project.[16] Until recently, Kern River shippers entered into 10- or 15-year service agreements. The potential risk of Period One shippers not contracting for Period Two has always been present, but given the design of Kern River's levelized rates, which results in a Period Two rate that is significantly lower than the Period One rate, it was anticipated that the Period One shippers would recontract for Period Two service.[17]

As the Period Two notification deadline approached for the 2003 Expansion 15-year shippers, market conditions were such that the forward market prices for Kern River capacity in the initial years of Period Two was below the Period Two tariff rate.[18] Kern River proactively initiated discussions with customers to address Period Two contracting issues in advance of shippers making the decision whether to recontract Period Two

[15] *Kern River Gas Transmission Co.*, 92 FERC ¶ 61,061 (2000). *Kern River Gas Transmission Co.*, 158 FERC ¶ 61,078 (2017).

[16] *Kern River Gas Transmission Company*, Order Approving Certificate, 132 FERC ¶ 61,226 (2010). As a result of the Apex Expansion, Kern River's annualized design capacity increased to 2,166,575 Dth/day.

[17] In the original certificate order, the Commission authorized Kern River to collect 70 percent of its investment in Period One and 30 percent in Period Two. *Kern River Gas Transmission*, 50 FERC ⁋ 61,069, 61,150 (1990) (Original Certificate Order).

[18] Exhibit "5." 2003 Expansion Group.

capacity, i.e., the “turn back” capacity.[19] Kern River proposed various alternatives to shippers to mitigate this recontracting risk and avoid the loss of a significant known or measurable revenue stream. Ultimately, Kern River and its customers reached agreement on one of the proposals, the “Alternate Period Two” rate proposal, which was filed as an uncontested settlement and approved by the Commission January 27, 2017.[20] The Alternate Period Two settlement offered a rate lower than the 10- and 15-year Period Two rates set forth in Kern River’s tariff, and importantly, a rate more competitive with forward market prices.[21] Even though the settlement was uncontested, only 35 percent of the capacity expiring April 30, 2018, was recontracted and 494,622 Dth/day was turned-back to Kern River bringing a total of 648,092 Dth/day capacity uncontracted, representing approximately 30 percent of the capacity utilized in Kern River’s determination of rates. Subsequent to the Alternate Period Two settlement, Kern River made proposals designed to encourage shippers to contract for Period Two by offering a rate option that was lower than the original Period Two and Alternate Period Two tariff rates. However, none of the subsequent proposals were accepted by Kern River’s customers.

III. STATEMENT

A. <u>The Commission’s statutory obligation is to approve rates that are just and reasonable.</u>

As recognized in the Final Rule, the Commission is not requiring that all interstate natural gas pipelines make a rate reduction based on FERC Form No. 501-G. A number of pipelines are expressly exempt from even filing such form; much less making whatever

[19] Kern River’s tariff required shippers to provide notice to Kern River of whether they will elect Period Two one year in advance of the commencement of Period Two service.
[20] *Kern River Gas Transmission Co.*, 158 FERC ¶ 61,078 (2017).
[21] Id. at P 2.

rate reduction would be suggested if they were to file such form. In exempting pipelines that file pre-packaged, uncontested rate settlements or are engaged in general NGA section 4 rate cases or NGA section 5 proceedings from the FERC Form No. 501-G filing requirement, the Commission recognized that the rates ultimately approved for each of those pipelines may not be identical to the rates that would result from each such pipeline's filing of FERC Form No. 501-G. This result comports with the Commission's statutory obligation to approve rates for a pipeline that are just and reasonable based on the individual facts and circumstances involving each pipeline. Similarly, the Final Rule recognizes that those pipelines filing FERC Form No. 501-G are not necessarily required to reduce rates exactly as suggested by such form if they make a commitment to file a general NGA section 4 rate case in the near future, file a statement explaining why the suggested reduction to rates is not needed, or have their rates determined in a NGA section 5 proceeding. Once again, the Commission's statutory obligation is to approve rates for a pipeline that are just and reasonable based on the individual facts and circumstances involving each pipeline.

B. <u>Kern River's return on equity is not unjust and unreasonable based on its individual facts and circumstances.</u>

The actual return on equity for calendar year 2017 is 9.8 percent.[22] This 9.8 percent return on equity, is *below* the 11.55 percent return on equity authorized for Kern River by the Commission in Kern River's last rate case.[23] Thus, the 2017 Form 2, which is the data used to produce the FERC Form No. 501-G calculation, demonstrates that Kern River

[22] Exhibit "2."

[23] *Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034 at P 30 (2009).

under-recovered its return on equity in 2017. In fact, Exhibit "7" shows Kern River has not earned its authorized return of 11.55 percent in any of the last five years.

These actual results are in stark contrast to the return on equity portrayed when Kern River mechanically completes the FERC Form No. 501-G, as directed by the Commission and without regard to whether the required adjustments to the filed Form 2 data apply to Kern River's individual facts and circumstances. Consistent with the Commission's specific instructions, Exhibit "1" is the FERC Form No. 501-G, applying actual 2017 Form 2 data, adjusted for an imputed capital structure with a 57 percent equity ratio and a corporate income tax rate of 21 percent. Exhibit"1" shows Kern River's estimated 2017 return on equity to be 21.4 percent.[24] Although 21.4 percent is the result of strictly following the Commission's instructions, it is misleading, as it does not reasonably reflect Kern River's unique facts and circumstances. Specifically, it does not reflect the inherent differences in the levelized rate structure the Commission authorized for Kern River or the prior period adjustments required to appropriately reflect the Alternate Period Two settlement approved by the Commission. Both of these adjustments are required to properly use the 2017 Form 2 data for the purpose of developing a cost and revenue study to determine whether to initiate a NGA section 5 investigation. Neither of the adjustments would be typical for a pipeline with a traditional rate design, but rather are uniquely associated with Kern River's levelized rate design, which has been consistently affirmed since it was ordered by the Commission in the Original Certificate Order.

[24] Returns with tax reform assume a preliminary calculation of the amortization of the excess deferred income taxes using the Reverse South Georgia Method as Kern River's tax accounting system does not have the information necessary to utilize the Average Rate Assumption Method.

C. <u>Adjustments are required for FERC Form No. 501-G to accurately reflect Kern River's levelized rates.</u>

In the Final Rule, the Commission said the One-time Report is an informational filing that serves two purposes: (1) to help determine whether to initiate NGA section 5 investigations of pipelines' rates and (2) as support for limited NGA section 4 filings pipelines may choose to make.[25] In regard to the first purpose, the Commission said the FERC Form No. 501-G was designed in a "manner that will produce an estimated return on equity that is as accurate as possible."[26] The Commission desires to use the One-time Report as a screening tool to analyze the impact of tax reform in an expedited manner. The Commission provided specific instructions for pipelines to follow to help ensure uniformity. Presumably, standardization allows the Commission to analyze the data consistently and more efficiently. Such a disciplined approach makes sense for traditional pipelines, but the standardization does not work for a nontraditional pipeline, like Kern River with levelized rates. As described above, Kern River's rate structure is not like other interstate pipelines. Simply transferring the Form 2 data into the One-time Report, which is used for the purpose of evaluating cost of service, produces inaccurate results because of the manner in which Kern River is required to calculate its levelized rates. Kern River's Form 2 data must therefore be adjusted in order to be accurately used for review of Kern River's rates. Specifically, Kern River identifies two types of adjustments that must be made in order to provide a reasonably accurate estimate of Kern River's return on equity

[25] Final Rule P 111.
[26] *Id.*

before and after the TCJA.[27] Each adjustment, individually and collectively, has a material effect on Kern River's return on equity.

i. ***Unique Levelization Methodology***

The Commission found in the Final Rule that it was appropriate for the FERC Form No. 501-G to use the imputed capital structure instead of the capital structure used in the pipelines' Form 2, "when it appears that the capital structure in the Form 2 [] does not comply with Commission policy."[28] Kern River's 100 percent equity capital structure complies with Commission policy. However, the One-time Report was designed to accommodate traditional pipelines, not Kern River's levelized rate structure, for which the Commission has repeatedly authorized a 100 percent equity capital structure.[29] When Kern River attempts to insert 100 percent equity into the form, it automatically imputes a 57 percent equity ratio. Forcing Kern River to impute a 57 percent equity capital structure results in an inaccurate and unreliable estimated return on equity, contrary to the desire expressed by the Commission in the Final Rule.[30]

The levelized rate design methodology approved under the optional expedited certificate regulations authorized in the Original Certificate Order requires Kern River to recover in Period One 70 percent of its invested capital, which was financed by debt and to recover in Period Two the remaining 30 percent of its invested capital, which was financed entirely by equity.[31] Kern River's 100 percent equity capital structure may be unusual, but it has been the policy of the Commission since the Original Certificate Order.

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[27] In the Final Rule, the FERC said, "FERC Form No. 501-G is intended to provide a rough estimate of the pipelines' return on equity." *Id.*
[28] *Id.* at P 111.
[29] *Kern River Gas Transmission Company*, 133 FERC ¶ 61,162 (2010).
[30] Final Rule at P 111.
[31] *Id.* at P 161.

The Commission consistently affirmed the use of 100 percent equity. In Opinion No. 486-D the Commission found:

> 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. That holding followed from the fact that the Period One rates are intended to permit Kern River to pay off its entire debt.[32]

The Commission unambiguously found: "[A] 100 percent equity capital structure is an integral part of the overall rate design approved by the Commission in the Optional Expedited Certificate."[33]

The single caveat the Commission has placed on Kern River's rates being designed using a 100 percent equity capital structure is in regard to refinancing of debt. The Commission has said if Kern River refinances its debt, 100 percent equity would not be appropriate.[34] Kern River has ***not*** refinanced its debt. Kern River fully satisfied, discharged and canceled its outstanding debt in accordance with applicable debt instruments May 8, 2017. Kern River's actual capital structure is 100 percent equity.

The FERC Form No. 501-G forced imputation of 57 percent equity capital structure violates the rate design principles approved in Kern River's original certificate proceeding, is contrary to unambiguous Commission precedent, and conflicts with the 2015 order of the United States Circuit Court of Appeals, District of Columbia, where the Commission successfully supported the Opinion No. 486 series of orders where the Commission found Kern River's Period Two rates were to be designed based on a 100 percent equity capital

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[32] *Kern River Gas Transmission Company*, 133 FERC ¶ 61,162 (2010) ("Opinion 486-D") P 161.
[33] *Id*. at P 161.
[34] Opinion No. 486-F P 151.

structure.[35] Moreover, imputation of a 57 percent equity ratio is inconsistent with the Final Rule.[36]

Estimating a return on equity for Kern River also requires use of an average rate base in accordance with its Commission-approved levelization methodology. FERC Form No. 501-G requires use of 2017 Form 2 data, which reflects an end of period balance, i.e., a balance as of December 31, 2017. In accordance with the Commission's instructions, Kern River used this end of period balance to produce the FERC Form No. 501-G set forth in Exhibit "1." However, in order to produce a reasonably accurate estimated return on equity that is consistent with Kern River's levelized rate models (and Commission precedent); the rate base line must be modified to reflect an average rate base. In Docket No. RP04-274, the Administrative Law Judge found that Kern River had carried its burden of proving its levelized cost-of-service/ratemaking methodology, including use of average rate base, which produced just and reasonable rates.[37] The Commission affirmed the Initial Decision in Opinion No. 486.[38] Exhibit "2" is the Adjusted FERC Form No. 501-G with actual 2017 Form 2 data, adjusted to reflect Kern River's actual 2017 average rate base and 100 percent equity.

For the foregoing reasons, Kern River requests the Commission to accept Kern River's adjustment to the FERC Form No. 501-G to properly reflect Kern River's 2017 Form 2 capital structure of 100 percent equity and average rate base. As shown in Exhibit "2," replacing the imputed capital structure with Kern River's actual 100 percent equity

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[35] Opinion No. 486-D P 161 and 195. *See also*, Opinion No. 486-E P 151 and Opinion No. 486-F P 151. *Aera Energy LLC, et al*.

[36] *Id*. at P 111 (Commission finds it appropriate to use an imputed capital structure "when it appears the capital structure reported in Form 2 *does not* comply with the Commission Policy").

[37] *Kern River Gas Transmission Company*, 114 FERC ¶ 63,031 at pp. 55-56 (2006) ("Initial Decision").

[38] *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 at p.37 (2006).

capital structure, along with the use of the average rate base, reduces Kern River's estimated return by 8.1 percent, from 21.4 percent to 13.3 percent.

ii. Prior Period Adjustments

Kern River's FERC Form No. 501-G, which is based on the 2017 Form 2 data, includes accounting changes not related to Kern River's 2017 cost of service and therefore skews the calculated return on equity. Accounting adjustments are necessary to remove rate refunds and depreciation changes booked in 2017 as a result of a rate settlement, but that relate to prior years' activity.

On January 27, 2017, the FERC approved the Alternate Period Two settlement filed by Kern River to establish an alternative set of reduced rates for eligible shippers[39] that elect Alternate Period Two service, pursuant to the terms of the stipulation.[40] The Alternate Period Two settlement provided a lower rate option to customers, attempted to improve the likelihood of recontracting expiring capacity and extended recovery of Kern River's rate base. The reduction in rates was accomplished by extending the levelized depreciation term to 25 years. The lower rate started on the date any electing shipper commenced Period Two service, notwithstanding whether that date had already occurred. For instance, the 2002 Expansion 10-year shipper that elected Alternate Period Two service received the lower rate on the settlement's effective date, and received a refund for the difference between the shipper's current Period Two rate and the lower Alternate Period Two rate back to May 1, 2012, the date the 2002 Expansion 10-year shipper commenced Period Two service. Additionally, the settlement required Kern River to adjust, as of the beginning of Period Two, depreciation rates to reflect the longer, 25-year depreciation rate. Similar to

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[39] Kern River FERC Gas Tariff Section 30.1 (d).
[40] *Kern River Gas Transmission Co.*, 158 FERC ¶ 61,078 (2017).

the rate adjustment described above, depreciation also had to be adjusted back to the date each electing shipper stepped down to Period Two. These adjustments were required to ensure all shippers were treated the same, regardless of whether a shipper elected Alternate Period Two service.

Kern River reported, in its Form 2, that December 31, 2017 Form 2 includes $4.8 million of refunds required by the Commission-approved Stipulation and Agreement[41] including $3.0 million refunded for prior periods provided to shippers that elected the new lower rates at step down to Period Two prior to 2017. In addition, the December 31, 2017 Form 2 includes adjustments for levelized depreciation for the Alternate Period Two contracts extending from 10- or 15-year periods to a 25-year period and a change in the book depreciation rates beginning March 1, 2017.[42] These changes caused a reduction of Kern River's regulatory liability for levelized depreciation on utility plant of $16.0 million, including $13.7 million for levelized depreciation prior to 2017. This reduction in the regulatory liability was reported as a regulatory credit.[43] Exhibit "2" is the FERC Form No. 501-G with actual 2017 Form 2 data, adjusted to remove the impact of the rate refund and depreciation adjustments associated with periods prior to 2017. The depreciation and refund amounts related to 2017 were not adjusted. Detailed supporting schedules consistent with 18 CFR § 154.312 with source references are set forth in Exhibit "9." As shown in Exhibit "2," these adjustments reduce Kern River's estimated return on equity by 0.8 percent.

[41] FERC Form 2, Notes to Financial Statements, p. 122.13

[42] *Id.* at pp. 122.10-122.11.

[43] *Id.*

In summary, when the adjustments necessary to reflect Kern River's unique levelized rate structure and the prior period adjustments are made to the FERC Form No. 501-G, Kern River's 2017 return on equity is, 12.5 percent, not 21.4 percent. Exhibit "2" presents each adjustment in the FERC Form No. 501-G format. These adjustments are summarized in Table 1.

Table 1: Return on Equity Adjustments

2017 ROE per FERC Form No. 501-G (Includes Tax Reform and 57% Equity)	21.4%
Impact of Levelized Rate Design	-8.1%
Removal of Alternate Period Two Prior Period Adjustments	-0.8%
Adjusted 2017 ROE (Includes Tax Reform)	**12.5%**

While the adjusted FERC Form No. 501-G return of 12.5 percent is above Kern River's authorized return of 11.55 percent, it must be considered in the context of the volatility and contracting risk that Kern River is now exposed to, which is not fully reflected in Kern River's 2017 Form 2. The adjusted 2017 return on equity of 12.5 percent is not necessarily an "accurate estimate," but it provides a better starting point for the Commission to decide whether a NGA section 5 investigation is appropriate.

D. FERC Form No. 501-G does not reflect the change in circumstances on Kern River.

FERC Form No. 501-G relies entirely on the financial data provided by Kern River in its 2017 Form 2 for the 12 months ending December 31, 2017. The Form 2 reports past performance for the 2017 calendar year.[44] Form 2 data is historical in nature and, by

[44] *Revisions to Forms, Statements & Reporting Requirements for Nat. Gas Pipelines*, 122 FERC ¶ 61,521 (2008).

definition, does not reflect activity subsequent to the end of the period reported. A tool designed to report historical data should not be used as the sole means to evaluate the reasonableness of current rates, particularly in times of significant change. This is precisely the problem with only using Form 2 data as the basis for evaluating whether a NGA section 5 investigation should be initiated. In short, given the significant market and contract changes on Kern River, the 2017 Form 2 is already outdated. Specifically, Kern River's 2017 Form 2 data does not take into account: (1) the revenue impact of 2018 capacity turned-back and not recontracted on a long-term basis or at tariff rates, (2) the significant competition Kern River faces for delivering natural gas to Southern California, and (3) the lower market value of Kern River capacity from the Rocky Mountains to California. The fact that prevailing market conditions prevented Kern River from reselling unsubscribed capacity of 648,092 Dth/day for a rate and term anywhere near the historical terms reflected in the Form 2 revenue, precludes a finding based on 2017 Form 2 information that Kern River's current rates are unjust and unreasonable, with or without the effect of tax reform.

i. 2017 Form 2 Data Does Not Reflect 2018 Contract Turn Back

In 2018, 494,622 Dth/day of capacity, representing approximately 23 percent of Kern River's design capacity was relinquished and not recontracted on a long-term basis. Prior to being turned-back, the capacity had been under long-term firm agreements at maximum tariff rates. This turn back capacity, together with the capacity available because of smaller turn backs in previous years, left Kern River with 648,092 Dth/day of long-term unsubscribed capacity available May 1, 2018. As shown in Exhibit "4," the load factor of Kern River's contracted long-term firm capacity decreased from 94.4 percent in 2017 to 70.1 percent in 2018. Although Kern River pursued extraordinary steps to resell the capacity under long-term firm contracts, market conditions and prevailing market prices, which were significantly less than the applicable tariff rate in the near term, made it impossible to recontract all of the available capacity. Notwithstanding these efforts, including the uncontested Alternate Period Two rate settlement,[45] Kern River was only able to sell 35 percent of the 2003 Expansion 15-year capacity subject to turn back on May 1, 2018, under long-term firm contracts.[46] Instead, in an effort to maximize the value of the turned-back capacity, Kern River resorted to selling the turned-back capacity through short-term, volumetric, index-based contracts. By their nature as short-term, volumetric, index-based agreements, these contracts fail to provide Kern River the contract duration and revenue level characteristics realized from the long-term firm, maximum tariff rate agreements that were in place prior to May 1, 2018, i.e., throughout the period reported in Kern River's Form 2. These short-term, volumetric, index-based contracts represent a substantial departure from the manner in which capacity has traditionally been marketed and sold on Kern River. The decreased interest in long-term firm, maximum tariff rate capacity reflects a trend that is expected to continue in the future and is certain to be a main component of Kern River's next section 4 rate case. Contract turn back will have a material impact on the known and measurable revenue level and billing determinants included in the cost of service.

The contract turn back that occurred May 1, 2018, reflects a material change in circumstances to the period ending December 31, 2017. These changed circumstances

[45] [Federal Energy Regulatory Commission Docket No. RP17-248, Letter order approving Kern River Gas Transmission's filing of a petition for approval of a Stipulation and Agreement under RP17-248, January 27, 2017.]

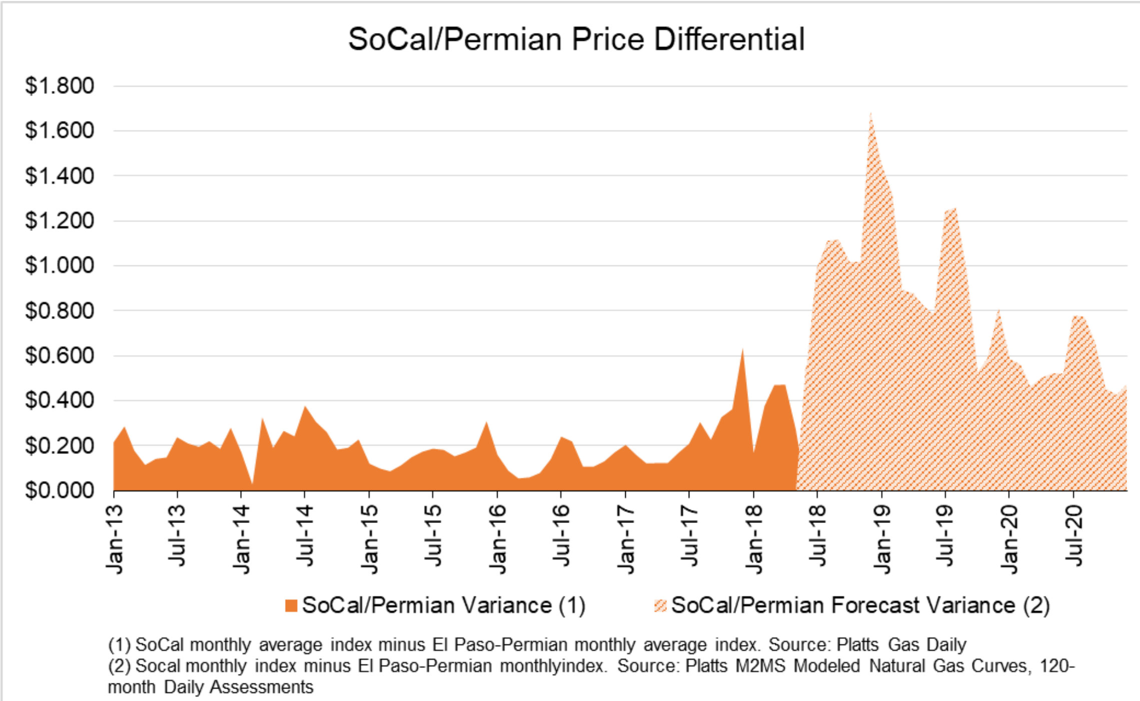
[46] As shown in Exhibit "10," 272,000 Dth/day of 766,622 Dth/day of the 2003 Expansion 15-year capacity was contracted for Period Two at the applicable Period Two tariff rate.

make achieving, let alone exceeding, the authorized return more difficult, even with the help of the lower corporate income tax rate. The inability to sell approximately 650,000 Dth/day of unsubscribed capacity under traditional long-term firm agreements at maximum tariff rates has exposed approximately 30 percent of Kern River's capacity and associated revenue to the volatility of market prices. Therefore, whether Kern River will achieve its authorized rate of return will largely depend on the daily index price of natural gas for spreads between the Rockies and Southern California. Even if the volatility and daily price spreads happen to allow Kern River to achieve its authorized return in any one year, it does not mean the authorized return will be achieved every year. The material changes in the market represent a significant revenue risk for Kern River that is not reflected in the One-time Report.

ii. 2017 Form 2 Data Does Not Reflect the New Reality that Kern River is the Swing Pipeline to California

In addition to the 2017 Form 2 data not reflecting the substantial capacity turn back referenced above, such data masks the significant change in Southern California market dynamics that impacted the value of Kern River capacity. The most significant change is the availability of natural gas from the Permian Basin. Pipelines such as El Paso and Transwestern have transported natural gas from the Permian Basin to Southern California for decades. However, the recent resurgence in the Permian Basin, driven by improved technology and production techniques, has caused a fundamental paradigm shift.

Chart 1: SoCal/Permian Price Differential

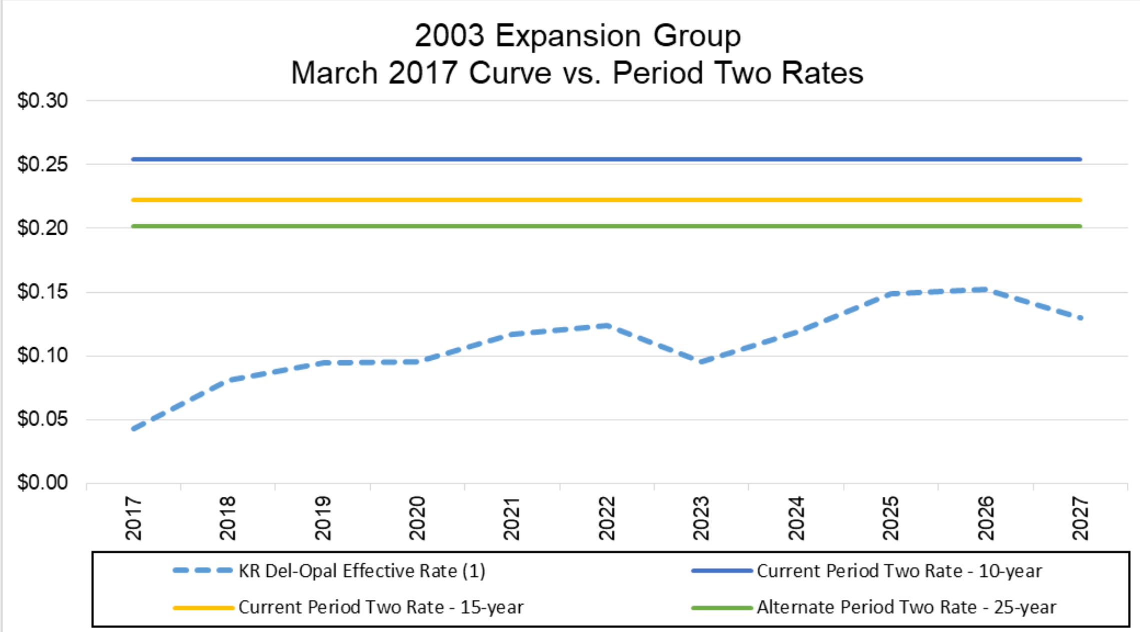


As shown in Chart 1, the significant Permian Basin production increase is a recent dynamic. As early as the fall of 2013, the global research and consultancy firm Wood Mackenzie did not foresee this increase. However, by the spring of 2018, production forecasts for the Permian Basin increased significantly. Wood Mackenzie reports the rig count in the Permian Basin increased by 115 rigs in 2017, four times greater than in any other basin. As of April 6, 2018, the Permian Basin rig count is 444 of a total 1003 in the United States. This dramatic increase in production, combined with insufficient pipeline takeaway capacity, has significantly reduced natural gas prices in the Permian Basin.

Given that there is excess interstate pipeline capacity available to serve Southern California, these market conditions provide the pipelines transporting natural gas from the Permian Basin to California a pricing advantage relative to pipelines such as Kern River that transport natural gas from the Rocky Mountains to Southern California. Although it is a benefit for shippers in Southern California to have access to multiple supply basins, under current market dynamics, where shippers have a price advantage to purchase Permian supplies, the value of Kern River capacity out of the Rockies is depressed. The market value of Kern River capacity is generally reflected by the difference in the price of natural gas at the Opal receipt point in Wyoming and the Kern River delivery point in Southern California. The significant level of production in the Permian Basin and the dearth of pipeline take away capacity allow shippers to purchase Permian Basin gas delivered to Southern California on El Paso and Transwestern for significantly less than the same shipper can purchase gas delivered to Southern California from the Rockies. Exhibit “12” shows the variance in spreads between the Permian and Rockies since 2013. Exhibit “12” paints a clear picture of why, under current market conditions, shippers in Southern California have a strong incentive to purchase gas in the Permian rather than the Rockies. The relatively low-cost Permian Basin supplies have significantly affected the value of Kern River capacity.

Chart 2 below shows the market value of Kern River capacity relative to the tariff rates available to the 2003 Expansion 15-year shippers at the time elections for Period Two service were being made. These prevailing market conditions caused many of the 2003 Expansion 15-year shippers to choose not to contract for Period Two service.

Chart 2: 2003 Expansion Group/March 2017 Curve vs. Period Two Rates



(1) Kern Delivered to Opal spread adjusted for fuel, commodity/usage fee, ACA, and other variable costs.
Source: March 1, 2017 - March 25, 2017 Platts M2MS Modeled Natural Gas Curves, 120-Month Daily Assessments

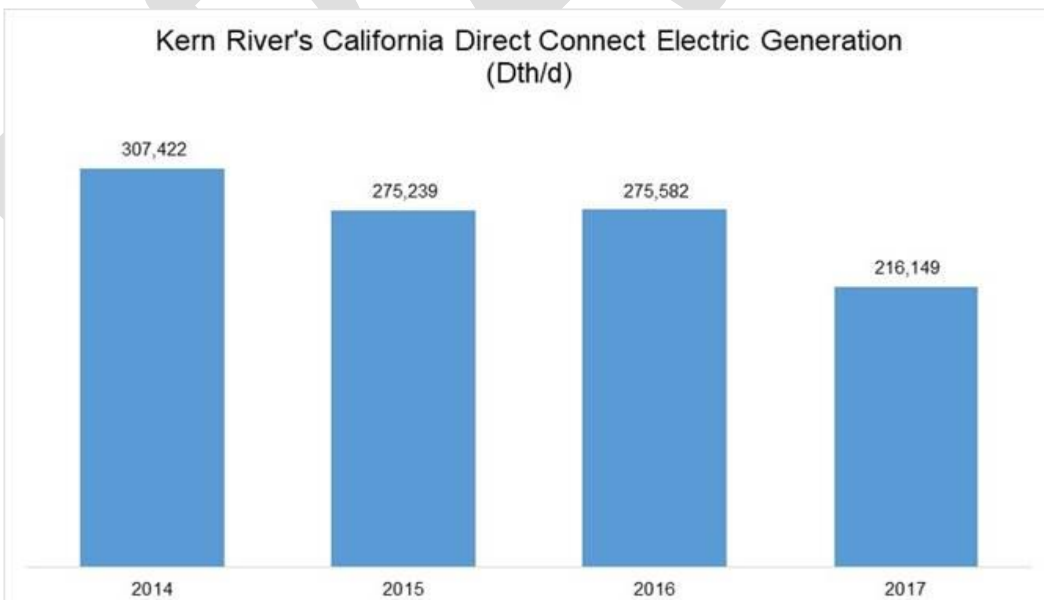
In addition, because of the lower prices in the Permian relative to the Rockies, shippers in Southern California that make a choice on the margin generally look to purchase their supplies from the Permian Basin and secondarily from the Rockies when market conditions are tighter. These conditions have materially affected Kern River's ability to sell long-term firm capacity at maximum tariff rates. Kern River's Form 2 data, and therefore the FERC Form No. 501-G data, fail to reflect this fundamental change in circumstances because, prior to May 1, 2018, Kern River's revenues reflected the long-term maximum tariff rates of the 2003 Expansion 15-year shippers. Therefore, the revenue impact related to turn back capacity came to fruition beginning in May 2018, after Kern River filed its 2017 Form 2 with the Commission. Failure to appreciate and reflect such a material change in circumstances would produce inaccurate and unreliable results.

iii. 2017 Form 2 Data Does Not Reflect the Lower Demand for Natural Gas in California

Until 2017, the vast majority of Kern River capacity was contracted under long-term firm, maximum tariff rate agreements. When these agreements were entered into, demand for long-term capacity on Kern River's pipeline was far greater than it is currently. In addition to the significant change in circumstances demonstrated above, the ongoing decline in demand for natural gas in Southern California is placing additional pressure on Kern River's ability to sell long-term capacity at rates that will cover its cost of service.

Daily average demand for capacity on Kern River's pipeline is lower than it has ever been.[47] As shown in Chart 3, Kern River's service to direct connect electric generators in its primary market of California has declined nearly 30 percent over the last four years (2014-2017).

Chart 3: Kern River's California Direct Connect Electric Generation



Furthermore, as reported in the 2018 California Gas Report, demand for natural gas in Kern River's primary market has decreased and is projected to shrink at a rate of 0.74

[47] A discussion of Kern River's efforts to recontract this expiring capacity is below in section III.C.iii.

percent per year for the next 17 years, due to conservation and the development of renewable energy to meet state mandates.[48] Data reported by the California Independent System Operator ("CAISO"), the entity responsible for maintaining the balance between supply and demand for electricity throughout most of California, indicates that thermal generation in California has declined 10.6 percent per year since 2013. From 2013 to 2017, renewable generation within CAISO has grown 13.8 percent per year offsetting demand for natural gas in California by an average of 116,462 Dth/day year-over-year. In 2018 alone, renewables are projected to offset thermal electric generation by an incremental 1,060 MW per day over 2017 renewable generation levels; a 16.8 percent increase, equivalent to 163,902 Dth/day that will no longer be needed in the California market.[49]

The ongoing decline in California natural gas demand, by itself, is not the reason Kern River has failed to earn its authorized rate of return of 11.55 percent in any of the last five years,[50] but it has contributed to it and it has certainly made selling capacity to California, Kern River's primary market, increasingly more challenging.

E. **<u>There is no basis to adjust Kern River rates solely on a change in the corporate tax rate.</u>**

As the Commission is well aware, a pipeline's costs and revenues vary from year to year, and the actual return on equity in any given year that results from these variations is rarely, if ever, the exact return on equity authorized by the Commission. The Commission's rationale for generally not requiring a change in rates to reflect one item of cost or revenue for one year is based on the understanding that costs and revenues vary

[48] *California Gas and Electric Utilities*, <u>2018 California Gas Report</u>, page 64. The California Gas Report is prepared in compliance with California Public Utilities Commission Decision No. 95-01-039.
[49] Dekatherm equivalence value assumes a utilization rate of 100 percent and a heat rate of 7.6 MMBtu/MWh.
[50] *Supra* Section III. B.

from year to year and may result in under-recovery or over-recovery of the pipeline's authorized return in any given year.[51] The 12.5 percent adjusted return on equity for 2017 produced from applying the lower federal income tax rate to Kern River's adjusted 2017 costs and revenues is not a sustainable return. The financial impact of the turn back is real and will have a real impact on Kern River's next rate case.

Moreover, even assuming the adjusted FERC Form No. 501-G return on equity of 12.5 is a reasonable estimate of Kern River's return, finding a 12.5 percent return on equity to be unjust and unreasonable would be contrary to the Commission's past actions, which have been to only initiate NGA section 5 proceedings against pipelines having much higher returns on equity. For example, after reflecting the impacts of the TCJA, the Commission recently instituted NGA section 5 proceedings against pipelines having calculated returns on equity ranging from 20.2 percent to 30.9 percent.[52] Since 2009, when the Commission first began instituting NGA section 5 proceedings based on calculations of pipelines' rates of return, the Commission has never commenced a NGA section 5 proceeding against a pipeline with a calculated return on equity below 16.6 percent.[53] Under this Commission standard, there is no basis for the Commission to determine that a 12.5 return on equity is sufficient to support a NGA section 5 proceeding with respect to Kern River.

If the Commission fails to take into account Kern River's unique facts and circumstances and initiates a NGA section 5 proceeding, it will trigger a general NGA

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[51] Final Rule at P 11.

[52] *Midwestern Gas Transmission Co.*, 162 FERC ¶ 61,219 (2018) (19.2 percent return on equity in 2015 and 20.2 percent return on equity in 2016); *Dominion Energy Overthrust Pipeline, LLC*, 162 FERC ¶ 61,218 (2018) (23.4 percent return on equity in 2015 and 19.9 percent return on equity in 2016). In both dockets, the referenced returns reflect the Commission's calculation of the benefit from the Tax Cut and Jobs Act.

[53] Exhibit "13." In Docket No. RP17-303, the Commission initiated a section 5 proceeding after calculating NGPL's return on equity to be 20.8 percent. *Natural Gas Pipeline Company of America*, 158 FERC ¶ 61,044 (2017). After ordering the investigation, the Commission corrected its calculated return to be 15.7 percent. *Natural Gas Pipeline Company of America*, 158 FERC ¶ 61,111 (2017).

section 4 rate case filing by Kern River that would involve many highly complex and contentious issues, including cost allocation and rate design changes necessary to reflect contract turn back. Kern River's levelized rate structure does not allow for simple rate calculations. The varying length of the terms of contracts and unique levelized cost of service for each of the various shipper groups must be considered in order to properly allocate costs and avoid under-recovery or over-recovery. Kern River's last NGA section 4 rate case proceeding took nearly ten years to complete.

Kern River has avoided filing a general NGA section 4 rate case through cost reductions and the reductions in rates achieved by extending the depreciation period in the Alternate Period Two Rate Settlement recently approved by the Commission.[54] A Commission decision finding existing rates are not unjust and unreasonable, notwithstanding the corporate tax rate reduction, would allow Kern River to continue to defer a rate increase despite significant turn back and market pressures.

IV.
CONCLUSION

WHEREFORE, Kern River respectfully requests the Commission to find that, based on all the facts and circumstances related to Kern River's costs and revenues, there is no basis for concluding that Kern River's rates are unjust and unreasonable, and, accordingly, no rate adjustment is necessary.

Respectfully submitted,

KERN RIVER GAS TRANSMISSION COMPANY

[54] *Kern River Gas Transmission Co.*, 158 FERC ¶ 61,078 (2017).

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