

1 **Q.** Please state your name, title and business address.

2 **A.** My name is John R. Smith. I am Vice President, Marketing and Regulatory
3 Affairs of Kern River Gas Transmission Company (“Kern River”). My business
4 address is 2755 East Cottonwood Parkway, Suite 300, Salt Lake City, Utah
5 84121.

6 **Q.** What are your current responsibilities?

7 **A.** In my current position, I direct the activities of employees in Kern River’s
8 Regulatory and Governmental Affairs, Marketing and Customer Services, and
9 Business Development and Strategic Planning departments. I am responsible for
10 tariffs, certificates, rates, regulatory filings, scheduling pipeline services,
11 contracting, relationships with customers and regulatory agencies, governmental
12 affairs and business expansion projects. My duties also include developing and
13 implementing Kern River’s responses to changing circumstances in the natural
14 gas industry.

15 **Q.** Please summarize your professional background.

16 **A.** I joined Northwest Pipeline Corporation (“Northwest Pipeline”) as a Customer
17 Relations Representative in 1977. Between 1977 and 1987, I held various

1 managerial positions in Regulatory Affairs. In 1985, I became one of the original
2 members of the Kern River Project development team, a joint venture between
3 The Williams Companies Inc. ("Williams") and Tenneco Inc. In 1988, I assumed
4 the position of Manager, Kern River, in which I was responsible for regulatory
5 affairs, marketing and governmental affairs for the Kern River Project. Upon
6 certification of the Kern River Project in 1990, I returned to Northwest Pipeline in
7 the capacity of Advisor, Economic and Strategic Planning. In 1993, I was named
8 Director of Business Development of Northwest Pipeline and was responsible for
9 system expansions and the development of other projects designed to capture new
10 market and storage opportunities. In 1997, I was named Director, Regulatory
11 Affairs and Strategic Planning. In that position, I was responsible for strategic
12 planning, rate case filings, and certificate and tariff applications for both
13 Northwest Pipeline and Kern River. In March 2002, after the acquisition of Kern
14 River by MidAmerican Energy Holdings Company ("MEHC"), I was named
15 Director, Regulatory and Governmental Affairs of Kern River. I held that
16 position until I assumed my current position in January 2004.

17 I hold a Bachelor of Science degree in Political Science (1974) and a
18 Master of Business Administration degree (1977) from the University of Utah.

19 **Q.** What is the purpose of your direct testimony?

20 **A.** Under the terms of its Docket No. RP99-274 rate case settlement, Kern River is
21 obligated to file a rate case no later than May 1, 2004, with new rates to become
22 effective by November 1, 2004. In compliance with this requirement, Kern River
23 is submitting in this proceeding proposed rate and tariff changes pursuant to
24 Section 4 of the Natural Gas Act. My testimony is offered in support of these

1 changes and focuses on overall rate case policy and Kern River's business risks.

2 My testimony also explains the basis for the proposed tariff changes.

3 **Q.** Please describe the general context in which Kern River is filing this general rate
4 case.

5 **A.** The Kern River pipeline was constructed in the early 1990's at a cost of
6 approximately \$1.0 billion, primarily to serve the enhanced oil recovery
7 operations in Kern County, California, in the vicinity of Bakersfield. After the
8 pipeline was completed in 1992, Kern River filed its initial rate case in Docket
9 No. RP92-226-000. That case was litigated to an initial decision by an
10 administrative law judge. Ultimately, the parties settled the case and the
11 Commission approved the settlement (70 FERC ¶ 61,072). One of the features of
12 the settlement was a requirement that Kern River file a new rate case within five
13 years thereafter.

14 Rather than filing the next general rate case as scheduled, Kern River
15 entered into negotiations with its shippers to "pre-settle" the matter. Those
16 negotiations were successful, resulting in the filing of a settlement to resolve the
17 issues in Docket No. RP99-274-000 on May 1, 1999. The Commission approved
18 the settlement as to most parties (90 FERC ¶ 61,124) and subsequently accepted
19 the formerly contesting party's consent to the settlement (98 FERC ¶ 61,245).
20 Embedded within Docket No. RP99-274 settlement were a number of important
21 provisions that have led up to the filing of this general rate case.

22 Specifically, the settlement provided that Kern River would not file a
23 general rate increase for a period of three years from the effective date of the
24 settlement; however, Kern River was obligated to file a general rate case no later

1 than five years from the effective date of the settlement rates. In addition, the
2 settlement, among other things, provided for a mechanism for Kern River to share
3 50% of any revenues it receives in excess of an adjustable, annual revenue
4 threshold. The settlement also resolved procedures for rolling in the cost of
5 expansions or provided for incremental rates for expansions during appropriate
6 circumstances. The settlement also contemplated the filing of a subsequent rate
7 settlement to further reduce rates beyond the \$.02 per Mcf initial rate reduction
8 contained in the Docket No. RP99-274 settlement.

9 The further rate reduction was made effective October 1, 2001, as
10 promised, when Kern River filed and the shippers supported a voluntary rate
11 reduction plan, known as the Extended Term (“ET”) Rate Settlement, in Docket
12 No. RP00-298-000. The rate reductions were made possible by the refinancing of
13 all of Kern River’s then-outstanding debt, coincident with extending the
14 depreciable life of the transmission plant. To effectuate this plan, shippers agreed
15 to contract term extensions of five or ten years. All of Kern River’s shippers
16 elected to participate in the contract term extensions and corresponding rate
17 reductions and, where applicable, waived certain most favored nations contract
18 rights (rights that provide certain shippers the opportunity to pay lower rates if
19 other firm shippers are offered lower rates).

20 In the spirit of continuing these cooperative rate resolutions, during 2003
21 Kern River entered into negotiations with its shippers in an attempt to “pre-settle”
22 the obligation to file this current rate case in the same manner as proved
23 successful in its last rate case. However, in early December 2003, Kern River
24 regretfully notified its shippers of its conclusion that the settlement process had

1 proven to be unsuccessful. The knowledge gained and views exchanged during
2 the settlement process, however, were no doubt useful to all of the parties.

3 **Q.** Please describe the testimony of Kern River's other witnesses in support of this
4 rate change filing.

5 **A.** Mr. Bruce Warner's testimony addresses rate design issues and the methodologies
6 used to levelize the costs of service. Mr. Martin Hansen provides testimony to
7 support Kern River's cost of service, including post-employment benefits other
8 than pensions (retiree medical plan costs) and rate base. Mr. Jeffrey Valentine
9 presents testimony and schedules on income taxes, regulatory assets and
10 liabilities, accumulated deferred income taxes and other taxes. Mr. Darrell
11 Swensen discusses matters pertaining to the weighted average cost of debt, capital
12 structure, affiliate billings, and procedures used to ensure an appropriate billing of
13 the direct costs related to Kern River's rolled-in services and the incrementally
14 priced expansion projects. He also supports Kern River's pension expense. Ms.
15 Lynn Dahlberg sponsors testimony related to revenues and reservation and
16 commodity billing determinants. Her testimony explains the computation of the
17 projected revenues from market-oriented services and proposed changes to
18 interruptible and authorized overrun fuel charges. In addition, she reviews the
19 credit status of Kern River's shippers. Mr. Edward Feinstein presents Kern
20 River's proposed depreciation rates for regulatory and book accounting. He also
21 supports the net negative salvage accrual rate. Mr. Michael Falk provides
22 testimony describing the utilization of compressor engines on the Kern River
23 system. Dr. Charles Olson's testimony presents an analysis of the appropriate rate
24 of return on common equity for Kern River, utilizing the Commission's return on

1 equity policies, including the effects of the unique financial and business risks
2 that Kern River faces.

3 **Q.** What terminology will you and Kern River's other witnesses use to refer to Kern
4 River's various facilities and services?

5 **A.** We will use the following terms:

- 6 • "Original System" refers to the facilities Kern River constructed in 1991-92
7 under the optional certificate issued in Docket No. CP89-2048-000 and the
8 related firm transportation service utilizing the capacity of those facilities;
- 9 • "CAP" refers to the California Action Project, an expansion constructed to
10 provide additional, short-term service to California markets in 2001 under the
11 certificate issued in Docket No. CP01-31-000;
- 12 • "2002 Expansion" refers to the permanent CAP facilities utilized for the 2002
13 Expansion project and other new mainline expansion facilities that Kern River
14 placed in service in 2002 under the certificate issued in Docket No. CP01-31-
15 001 and the related firm transportation service utilizing the additional capacity
16 created by that expansion;
- 17 • "Rolled-In System" refers collectively to Kern River's transportation services
18 related to the Original System and the 2002 Expansion, which are provided at
19 rolled-in rates based on the aggregate costs of those facilities;
- 20 • "2003 Expansion" refers to the mainline expansion facilities Kern River
21 placed in service in 2003 under the certificate issued in Docket No. CP01-
22 422-000 and the related, incrementally-priced firm transportation service
23 utilizing the additional capacity created by that expansion;
- 24 • "High Desert Lateral" refers to the lateral line in California of the same name,
25 constructed in 2001 and 2002, and the related transportation service provided
26 on that facility; and
- 27 • "Big Horn Lateral" refers to the lateral line in Nevada of the same name,
28 constructed in 2002, and the related transportation service provided on that
29 facility.

30 **Q.** Please provide a summary of the changes reflected in Kern River's Section 4
31 filing.

1 **A.** In general, Kern River proposes to maintain in this filing the cost of service and
2 rate principles approved in: 1) the original Kern River certificate, 2) the ET rate
3 settlement, 3) the 2002 Expansion certificate, 4) the 2003 Expansion certificate
4 and 5) Kern River's prior rate case settlements.

5 However, Kern River proposes modifications to certain components of its
6 existing rate and cost of service structure. Through the supporting testimony of
7 Mr. Feinstein, Kern River proposes new methods for depreciating compressors
8 and general plant. Mr. Feinstein also proposes implementation of a net negative
9 salvage allowance as a part of the required depreciation of transmission and
10 compression plant.

11 Dr. Olson recommends a rate of return on common equity for Kern River
12 of 15.1%, derived using the Commission's standard, accepted DCF methodology,
13 to compensate Kern River for its financial and business risks. Dr. Olson concludes
14 that the top of the proxy range provided by the DCF analysis is reasonable for
15 Kern River.

16 Mr. Valentine's testimony supports proposed adjustments to the Rolled-in
17 System rate base for the restatement of accumulated deferred income taxes related
18 to the acquisition of Kern River by MEHC, consistent with income tax law and
19 FERC policy. Mr. Valentine also explains an adjustment to accumulated deferred
20 income taxes, compared to the computations underlying the current, initial rates,
21 for the 2003 Expansion Project and other plant, to implement the bonus income
22 tax depreciation elections made available under new income tax statutes, and to
23 reflect Kern River's current inability to fully utilize the income tax deductions
24 related to such accelerated depreciation.

1 **Q.** Are there other changes reflected in Kern River's Section 4 filing?

2 **A.** Yes. Kern River proposes to eliminate the annual revenue sharing with firm
3 transportation customers that was part of the Docket No. RP99-274-000 general
4 rate settlement. Instead, Kern River proposes to credit market-oriented revenues
5 to its overall cost of service after certain rate design adjustments are made. Ms.
6 Dahlberg explains the derivation of the market-oriented revenues. Mr. Warner
7 explains the associated rate making proposals.

8 Kern River has adjusted the January 31, 2004 (end of base period)
9 balances of its plant investment and O&M and A&G expense accounts for known
10 and measurable changes through October 31, 2004, the end of the test period for
11 this filing. The plant investment update includes the cost of the 2003 Expansion
12 project of \$1.193 billion, which is \$70 million less than the \$1.26 billion estimate
13 included in the final 2003 Expansion certificate application and rate compliance
14 filing. The plant cost updates also include the cost of each of Kern River's 2002
15 Expansion and other capital expenditures projected to be in service by October
16 31, 2004.

17 **Q.** Please provide a summary of recent developments affecting Kern River's
18 operations.

19 **A.** Since the settlement of Kern River's Docket No. RP99-274 rate case, several
20 important events have occurred which have affected Kern River's business and
21 operations and which have contributed to the content of this rate filing. The most
22 significant of these events are:

23 ➤ Kern River placed the ET Rate Settlement in Docket No. RP00-298 into
24 effect and refinanced \$510 million of existing debt to implement the new,

1 lower ET rates. The settlement rates were implemented on October 1,
2 2001. For shippers electing 10-Year ET service, the settlement provided
3 in excess of a 28 percent rate reduction and the 15-Year ET shippers' rates
4 declined by more than 35 percent.

- 5 ➤ Kern River has completed several system expansion and extension
6 projects: the California Action Project ("CAP") expansion, 2002
7 Expansion, 2003 Expansion, High Desert Lateral and the Big Horn
8 Lateral.

9 The CAP expansion was incrementally priced and placed into
10 service on July 1, 2001. The permanent portion of these facilities later
11 became part of the 2002 and 2003 Expansion projects. The 2002
12 Expansion was placed into service on May 1, 2002 and was rolled into the
13 original system cost of service as provided for in the RP99-274 Settlement
14 Agreement. The 2002 Expansion resulted in a \$0.029 per Dth reduction in
15 reservation rates for Original System shippers. The 2003 Expansion was
16 priced incrementally and was placed into service on May 1, 2003. The
17 initial reservation rates that Kern River made effective at that time for
18 2003 Expansion service were \$.0479 per Dth lower for 10-year shippers
19 and \$.0564 per Dth lower for 15-year shippers than the rates approved in
20 the certificate order.

21 The High Desert Lateral was built and placed into service on
22 August 31, 2001. Service is provided utilizing incremental, levelized rates
23 under a negotiated agreement with the anchor shipper.

1 The Big Horn Lateral is a facility reimbursement arrangement
2 priced on an incremental, levelized cost of service basis. This facility
3 went into service at the end of 2002.

4 Altogether, Kern River has invested over \$1.3 billion in new
5 pipeline infrastructure to serve markets in California, Nevada and Utah
6 since 2001. Importantly, these projects brought significant benefits to gas
7 suppliers, shippers and the public. The projects were key to moving
8 stranded gas supplies in the Rockies to California during the California
9 energy crisis. These expansions significantly increased gas-on-gas
10 competition in California and provided a scarce and needed resource for
11 the generation of electricity, which was key to stabilizing California's
12 recovery from its 2001 energy crisis. All of these projects were built on
13 time and within budget.

14 ➤ On May 1, 2003, Kern River successfully amended its previous \$510
15 million credit facility to provide for an additional \$836 million of long-
16 term debt to finance its recent construction projects, including the 2003
17 Expansion and the High Desert Lateral, at a very favorable interest rate
18 (4.893% coupon rate).

19 ➤ New income tax laws significantly increased the income tax deductions
20 available for the investment in the 2003 Expansion and other recent capital
21 additions. The associated accumulated deferred income taxes reduce rate
22 base primarily for the 2003 Expansion shippers, as the associated cash
23 flow benefits are realized.

➤ During March 2002, Kern River was acquired from Williams by MEHC. Because of this transaction, a significant adjustment was made on the acquisition date to reduce Kern River's accumulated deferred income taxes ("ADIT") to zero and to "step up" the income tax basis of Kern River's plant. The rate base adjustment relating to the elimination of the ADIT, in isolation, increases the rates for Rolled-In System shippers.

This adjustment reflects the actual equity invested in Kern River's tax basis by MEHC. At the same time, Williams paid to the Internal Revenue Service ("IRS") all of the deferred income taxes owed by Kern River. This rate base adjustment is necessary to avoid violating IRS regulations concerning use of income tax normalization accounting, as explained in detail by Mr. Valentine. Avoiding a violation of the normalization regulations is ultimately beneficial to Kern River's shippers since it is necessary to protect Kern River's right to continue to elect accelerated income tax depreciation. That, in turn, protects the principle of ADIT continuing to be available to offset a portion of rate base in general rate cases and is consistent with Commission policy.

Q. What are the benefits of the MEHC acquisition to Kern River's shippers that also serve to support the fairness of the adjustment to ADIT?

A. The MEHC acquisition was key to securing significant, ongoing benefits for all shippers on the Kern River system.

The weak financial status of the industry and of Kern River's former parent, Williams, had reached the point in March 2002 (the MEHC acquisition date) that under Williams' ownership, Kern River was unlikely to be able to

1 finance the 2003 Expansion. Kern River's then-existing debt covenants required
2 a guarantee of completion of any expansion by Kern River's parent company or
3 another entity having an investment-grade credit rating (at least BBB- by
4 Standard and Poor's and Baa3 by Moody's). However, because of the Enron
5 debacle's effect on the energy industry and problems at Williams'
6 telecommunications and energy marketing units, by early 2002, Williams' credit
7 rating was under pressure and, by mid-year 2002, had been downgraded to below
8 investment grade. Additionally, Williams' situation had deteriorated to the point
9 that it did not have the financial resources to invest the required equity in Kern
10 River's expansion. Kern River nevertheless was contractually obligated to its
11 firm expansion shippers to build the project.

12 MEHC's acquisition of Kern River provided a speedy resolution to this
13 situation. MEHC had (and still has) an investment-grade credit rating (backed by
14 the AAA rating of its principal owner, Berkshire Hathaway Inc.). After acquiring
15 Kern River, MEHC immediately began work on financing the 2003 Expansion,
16 provided the necessary completion guarantee for the project, and made the
17 necessary equity contribution without which the expansion could not have been
18 built. The acquisition permitted Kern River to complete the expansion on time to
19 meet the shippers' needs for service commencing on May 1, 2003, e.g., to
20 accommodate completion of power generation projects, which supported the
21 continuing stabilization of the California energy market.

22 All shippers will receive continuing benefits from the acquisition through
23 the financial stability that MEHC provides. Because MEHC enabled Kern River
24 to timely complete the 2003 Expansion, the southwest Wyoming gas price

1 immediately stabilized at a significantly higher level, thus producing higher well-
2 head netbacks to producers who are also Original System Shippers. There is little
3 question that MEHC will be able to provide the equity needed to fund future
4 expansions and for system maintenance capital expenditures. MEHC has
5 significant experience in financing projects efficiently and cost effectively, thus
6 minimizing overhead charges allocated to Kern River and its shippers.

7 In addition, because of the successful completion of the 2003 Expansion,
8 about fifty percent of Kern River's administrative and general expenses and
9 operation and maintenance expenses will now be properly charged to the 2003
10 Expansion shippers, due to the doubling of the size of the Kern River system.
11 This cost sharing of approximately \$17.5 million provides a significant efficiency
12 benefit to the Rolled-in System shippers. Those shippers, assuming Kern River's
13 rate proposals are approved as presented herein, will receive additional financial
14 benefits due to lower debt financing costs through deriving their cost of service by
15 using a weighted average cost of debt. Additional benefits will evolve through
16 the years in the shared efficiencies of maintaining a larger system.

17 The completion of the 2003 Expansion also provides additional service
18 reliability to the Rolled-In System shippers through the looping of most of Kern
19 River's pipeline. This provides additional assurance that service would not be
20 disrupted in the event of unplanned outages of facilities and helps to minimize
21 maintenance-related reductions in service.

22 **Q.** Please summarize the major factors affecting Kern River's proposed
23 transportation rates, as compared to the current rates.

1 **A.** The most significant changes affecting Kern River's proposed rates are as
2 follows:

- 3 ➤ Updating O&M and A&G expenses to current cost levels;
- 4 ➤ Updating plant and accumulated deferred income tax balances to the
5 projected balances at the end of the test period, October 31, 2004, and
6 through each levelization period, where applicable, as well as reflecting
7 Kern River's expansions, the acquisition by MEHC and new income tax
8 laws;
- 9 ➤ Revising the depreciation methodologies applicable to compressor engines
10 and general plant to closely match their respective depreciation periods to
11 their actual asset lives;
- 12 ➤ Utilizing an updated, overall cost of debt of approximately 6.62 percent
13 for the Rolled-In System and the 2003 Expansion vs. 8.22 percent and
14 5.14 percent, respectively, underlying the prior rates;
- 15 ➤ Updating the cost allocation to market-oriented services to reflect current
16 projections for the twelve months ended October 31, 2004, and an
17 adjustment to recognize that a portion of the anticipated revenue will be
18 related to capacity previously held by a former firm 2003 Expansion
19 shipper for which Kern River is now at risk;
- 20 ➤ Utilizing a rate of return on equity of 15.1 percent, compared to 13.25
21 percent in current rates; and
- 22 ➤ Implementing direct charges and other cost allocation methodologies
23 described in Kern River's filing to apportion costs fairly between the
24 Rolled-in System and the incrementally priced expansions.

1 **Q.** Please summarize the overall rate impacts associated with Kern River's filing.

2 **A.** In general, the filing reflects:

3 ➤ An increase in rates for the Rolled-in System, due in major part to the
4 adjustment to accumulated deferred income taxes that occurred when
5 MEHC purchased Kern River, but also reflecting a higher rate of return on
6 equity, generally increased costs of service and a lower market-oriented
7 revenue credit; and

8 ➤ An increase in rates for the incrementally priced 2003 Expansion service
9 due to Kern River's overall higher cost levels (depreciation, return and
10 operating costs) and cost allocations between the Rolled-In System and the
11 2003 Expansion, offset in part by the effect of adjusting the investment in
12 the expansion to the current estimate of plant balances, by the market-
13 oriented revenue credit, and by the effect of bonus income tax
14 depreciation, which increased ADIT and reduced the rate base, as
15 explained in detail by Mr. Valentine.

16 **Q.** Please explain the tariff changes embodied within the rate filing.

17 **A.** Kern River has filed a number of ministerial changes to reflect minor updates to
18 the tariff required by this filing and four significant revisions required by changes
19 Kern River is proposing. These changes include: 1) revisions to Kern River's
20 Statement of Rates to effectuate the changes in rates proposed in this filing, as
21 supported by Mr. Warner; 2) the definition of recourse rates for each of Kern
22 River's services, also as supported by Mr. Warner; 3) a change to the fuel
23 reimbursement provisions of Kern River's tariff to set forth a proposed change in
24 the fuel reimbursement charges for interruptible and authorized overrun

1 transportation, as supported by Ms. Dahlberg; and 4) a proposal to remove the
2 revenue sharing tariff provisions, which were added as part of the settlement of
3 the RP99-274 rate case. Since that settlement will no longer be in effect, and
4 since Kern River will have an adequate history after completion of the 2003
5 Expansion to enable it to derive an appropriate credit to its cost of service to
6 reflect expected market-oriented revenue, continuing the revenue sharing
7 arrangement is unnecessary.

8 **Q.** What changes have affected Kern River's business environment and the risks
9 Kern River faces?

10 **A.** Several developments in the energy industry generally have affected Kern River
11 since the Docket No. RP99-274 rate settlement. Most prominent among these are
12 the California energy crisis and, as discussed below, the well-publicized financial
13 problems in the natural gas and electric industries that began with the Enron
14 meltdown and their ultimate bankruptcy. These events have affected the credit
15 quality of many of Kern River's shippers, both individually and as a group. This
16 has resulted in an increase in Kern River's business risks. Dr. Charles Olson
17 discusses these risks in more detail.

18 **Q.** Don't all major pipelines face similar business risks associated with shipper
19 credit?

20 **A.** As Dr. Olson explains in his prepared testimony, Kern River is uniquely situated
21 among pipelines, both with respect to the level of market concentration of electric
22 generation on its system, particularly related to the 2003 Expansion, and with
23 respect to the level of business risk it has undertaken under its levelized rate
24 structures for both the Rolled-in System and the 2003 Expansion. The levelized

1 rate structure affords Kern River's shippers the ability to enjoy lower rates at the
2 beginning of the levelization period and defer costs to later periods. In this
3 regard, Ms. Dahlberg's testimony includes information about the degree of
4 electric generation concentration and current credit profiles of Kern River's
5 shippers. Dr. Olson discusses the implications of the shippers' credit profiles to
6 his rate of return on equity analysis.

7 **Q.** In terms of shipper credit risk, doesn't Kern River's FERC tariff require
8 prospective shippers to satisfy credit standards as a condition to service?

9 **A.** Kern River's tariff contains a certain degree of credit protection for Kern River by
10 providing for parental guaranties or other collateral if a shipper is not investment
11 grade. However, when shippers are not investment grade, the principal alternative
12 forms of security under Kern River's tariff provide Kern River protection for only
13 one year's reservation charges. Therefore, a continuing, long-term adverse
14 economic environment affecting Kern River's shippers is a significant risk to
15 Kern River. Ms. Dahlberg's testimony details changes to the credit quality, since
16 Kern River filed the 2003 Expansion certificate application, of Kern River's
17 shipper group that relate directly to financial difficulties experienced by shippers
18 (or former shippers) and/or their parent companies. Similarly, future events
19 present a significant, ongoing risk to Kern River. Ms. Dahlberg discusses the
20 realized risks (financial losses and need for capacity rationalization), which Kern
21 River has already experienced through bankruptcy proceedings in the recent
22 environment.

23 **Q.** What are the implications for Kern River's finances over time in the event of
24 shipper bankruptcies or defaults?

1 **A.** The most immediate effect of such events is that Kern River faces the risks of re-
2 marketing turned-back capacity. Kern River already is realizing this type of risk
3 with respect to the contract that Mirant Americas Energy Marketing, LP
4 ("Mirant") rejected in its bankruptcy. Mirant is not the only shipper on Kern
5 River's system that has filed bankruptcy and turned back capacity. Enron Energy
6 and Trading turned back 31,200 Dth per day of CAP capacity and NRG Energy
7 Inc. turned back 20,200 Dth per day of 2003 Expansion capacity. The scope of
8 the turn-back risk will continue to increase if, as we expect, the Pinnacle West
9 Capital Corp. ("Pinnacle") contract is not renewed or extended before it expires
10 by its terms at the end of November 2004. Over the longer term, if capacity
11 turn-back continues and re-marketing remains difficult, like it is today, eventually
12 the under-recoveries of revenue that Kern River faces could have a negative effect
13 on its credit rating. A credit downgrade, in turn, would lead to higher interest
14 costs than otherwise would be obtained for any new debt financing that Kern
15 River might need to undertake to fund future capital requirements. All else being
16 equal, higher interest costs generally translate into higher rates for Kern River's
17 shippers. Therefore, it is in the interests of both Kern River and its customers to
18 maintain Kern River's financial health.

19 **Q.** What additional steps can Kern River take to mitigate its losses?

20 **A.** When Kern River experiences capacity turn-back events, its choices are to try to
21 sell the capacity long-term or short-term to other shippers or to rationalize its use
22 (to fill a new market demand). Kern River has contracts containing most favored
23 nations provisions which restrict Kern River's ability to resell its capacity on a
24 long-term basis at a discount. This is because, under certain conditions, a long-

1 term discount may trigger the rights of other shippers to the same lower price.
2 For this reason, Kern River, in the absence of a strong market which supports full
3 rate transportation, will generally sell its available capacity in the interruptible or
4 short-term capacity markets.

5 A future expansion project may provide an opportunity for rationalization
6 of turn-back capacity. Only if additional long-term markets can be secured would
7 Kern River have an opportunity to design its expansion with capacity turn-back in
8 mind so as to achieve a rationalization of such available capacity. Such
9 expansions are generally infrequent, as demonstrated by the fact that it was nine
10 years before market demand increased sufficiently for Kern River to expand the
11 first time after it was originally built in 1992. Existing shippers also compete
12 with the pipeline's rationalization efforts and can remarket their capacity through
13 capacity release and/or assignment transactions.

14 In summary, while Kern River may have opportunities to mitigate portions
15 of its losses when contracts are turned back, the risks usually can't be wholly
16 mitigated since market demand dictates the value of the capacity.

17 **Q.** What approach has Kern River taken in this rate filing with regard to its realized
18 capacity turn-back events?

19 **A.** Kern River recently has experienced a major turn-back of one of its firm 2003
20 Expansion contracts and related capacity. The affected contract was a 90,000 Dth
21 per day contract with Mirant. Mirant rejected (cancelled) its contract in its
22 bankruptcy proceeding during December 2003. In addition, Kern River
23 anticipates that the Pinnacle contract, which expires on November 30, 2004, will
24 not be renewed and that Pinnacle will replace the contract with released capacity

1 obtained from one of Kern River's other shippers, likely at a deeply discounted
2 rate due to current market conditions.

3 In the light of these factors, Kern River has developed the following
4 proposal, which it believes is fair and equitable, for treatment of the costs of its
5 turned-back capacity. Kern River proposes to continue to include the reservation
6 quantities associated with the Mirant contract in its firm transportation reservation
7 billing determinants used for rate design. However, to afford Kern River a
8 reasonable opportunity to recover the costs of the turned-back capacity, Kern
9 River proposes to reduce the credit to its cost of service for market-oriented
10 revenues (which reduces costs paid by firm shippers), to permit Kern River, in
11 effect, to retain the revenues from 90,000 Dth per day of market-oriented services
12 on a first-through-the-meter basis. Under this proposal and based on forward-
13 looking market conditions, Kern River probably would realize mitigation for less
14 than 50% of the cost of the Mirant contract. In addition, Kern River expects a
15 similar loss on the Pinnacle contract, though the contract expires after the end of
16 the test period. Kern River would not only lose all of its equity return, but also a
17 major portion of recovery of depreciation and operating costs on the capacity
18 associated with the turned-back contracts. Thus, Kern River would be fully at
19 risk to recover the costs of the capacity from the marketplace. This proposal, with
20 regards to Mirant, is further quantified and described by Mr. Warner and Ms.
21 Dahlberg in their direct testimony.

22 **Q.** What other factors support Kern River's proposal regarding capacity turn-back?

23 **A.** Kern River understands that the Commission does not permit bad debts from
24 uncollected accounts receivable to be included in a pipeline's cost of service. The

1 Commission has stated that such costs are compensated for by the pipeline's
2 return on equity allowance. In addition, the Commission's actions in past
3 proceedings indicate a preference for the pipeline to be primarily responsible for
4 working out ways to mitigate capacity turn-back issues, although the Commission
5 has also approved partial payments of such costs by remaining shippers in
6 settlement agreements. Therefore, Kern River believes that its rate design
7 proposal described above, along with a proper rate of return on equity, are the
8 appropriate means to partly compensate for the undeniable costs and risks
9 associated with capacity turn-back.

10 **Q.** Does Kern River confront other business risks?

11 **A.** Yes. Kern River faces a number of other, significant business risks. If competing
12 pipelines are expanded or constructed and/or additional gas supplies are attached
13 to the interstate grid to serve the same markets as Kern River's, Kern River may
14 be required to discount its rates to attract replacement shippers if other shippers
15 default on existing contracts or to extend existing agreements similar to Kern
16 River's previous ET program.

17 **Q.** Is this risk from competition real or merely hypothetical?

18 **A.** It is real and ongoing. Kern River presently competes for its primary markets
19 with four interstate pipeline systems (El Paso/Mojave, Transwestern, Questar
20 Southern Trails and Gas Transmission Northwest (formerly Pacific Gas
21 Transmission)) and with alternate energy supplies like LNG. Gas supplies that
22 compete in California with Kern River's Rocky Mountain gas are sourced from
23 California, western Canada and the Permian, Anadarko and San Juan Basins.
24 Moreover, several pipeline projects have been announced throughout the western

1 U.S., representing proposals to develop nearly 2.5 Bcf/d of incremental interstate
2 pipeline capacity that could serve California. Also, several more proposals within
3 California itself have been announced that would enhance delivery capacity for
4 other interstate pipelines and facilitate the entrance of LNG. Proposed
5 enhancements total as much as 1.5 Bcf/d of new capacity. In addition, at least
6 five LNG projects, with aggregate delivery capacity of approximately 5.4 Bcf/d,
7 have been proposed for entry into California or northwestern Mexico. Two of
8 these LNG projects have received significant Mexican government approvals and
9 have announced gas supply contracts. Although it is unlikely that all of these
10 proposals will be built, development of even one or two of the LNG projects will
11 present additional competitive challenges to Kern River for market share in
12 California. These projects could significantly devalue Kern River's capacity
13 through competition for markets.

14 **Q.** Are there supply-side risks as well?

15 **A.** Yes. Kern River is exposed to the possibility of supply constraints in the Rocky
16 Mountain region. This potential arises from continuing environmental and federal
17 land management restrictions on producers' access to potentially productive
18 drilling sites and from the construction of additional pipelines to move gas out of
19 the Rocky Mountains to both eastern and western United States markets. Kern
20 River's competitors for Rocky Mountain gas supplies have announced at least
21 eight interstate pipeline projects that would increase export capacity from
22 Wyoming by more than 3.8 Bcf/d. To my knowledge, very few gas production
23 areas in North America, if any, are the focus of such concentrated pipeline
24 development activity. A supply constraint in the Rockies caused by supply

1 shortages or diverted gas supply could adversely affect Kern River's load factors,
2 as well as the basis price differentials experienced between the Rockies and Kern
3 River's principal markets in California. An actual example of such an event was
4 the very low basis price differentials during the winter of 2003/2004, caused by
5 supply shortages resulting from supply diversion to Denver and Salt Lake City. In
6 addition, as Dr. Olson testifies, Kern River is exposed to potential changes in
7 favored sources of energy, such as increasing development of clean burning, coal-
8 fired electric generation. These market dynamics are a risk to Kern River in
9 particular because of its rate structure, which defers significant portions of
10 investment recovery to the later years of shipper contracts.

11 **Q.** Is Kern River subject to other risks that are not typical of other pipelines?

12 **A.** Yes. Most natural gas pipelines utilize the straight-fixed-variable ("SFV") rate
13 design, which includes no fixed costs in the firm transportation commodity rate.
14 Kern River, however, is proposing to continue its current, 6-cent per Dth
15 commodity rate. This rate design exposes the pipeline to real throughput risk in
16 the event of supply shortages and reduced demand resulting from a change in
17 electric generation patterns due to higher gas prices or high hydropower
18 availability. This rate design also reduces the risks to shippers by reducing their
19 fixed monthly payment responsibilities.

20 **Q.** Please explain, from your management perspective, why Kern River has accepted
21 Dr. Olson's rate of return recommendation of 15.1%.

22 **A.** While I am not a rate of return expert, I believe Dr. Olson's recommendation is
23 clearly reasonable. From a policy standpoint, the Commission's responsibility to
24 fairly balance the need to ensure adequate investment in pipeline facilities with

1 the need to maintain the lowest reasonable rates for consumers is very important.
2 To the extent the Commission strikes the right balance, pipelines will continue to
3 have an incentive to provide the necessary infrastructure to meet the growing
4 energy demands of the market place. Chairman Wood acknowledged the need to
5 incent pipeline investors to make the huge, long-term financial commitments that
6 major expansion projects require in a July 17, 2002 Commission meeting, where
7 he said:

8 [S]o long as pipelines are expanding and investing their pipeline
9 plant and making investments to broaden and increase the needed
10 transmission highway for natural gas, even if they are over earning,
11 I'm less inclined to support an action [under NGA Section 5]
12 unless it's way out of line. Those pipes that may not be plowing
13 their earnings back into pipeline planning and expanding across the
14 nation, I would say, would certainly be an area that we might look
15 at. . . . I do think it's important to let pipes know that that's very
16 important to us and has carrots and sticks attached to that.

17 **Q.** Has Kern River reinvested its earnings in expansions of its pipeline system?

18 **A.** Kern River has certainly invested heavily in improvements and expansions of its
19 system to provide badly needed infrastructure to serve its markets with natural gas
20 for retail consumption, electric generation and other uses. In fact, as shown in my
21 attached Exhibit KR-13, Kern River has reinvested nearly 82% of the total net
22 income it has realized since 1992, when it placed the Original System in service,
23 into expansions of its system and other new facilities, more than doubling the
24 mainline capacity of its system.

25 In addition, Kern River has financed its expansions in the most attractive
26 way possible for the benefit of shippers, as demonstrated by the very low interest
27 cost associated with Kern River's debt capital and its relatively high debt to
28 equity ratio. Kern River's equity investors have reasonably expected that Kern

1 River would receive and maintain an attractive, fair rate of return on equity, both
2 to compensate the equity holders for risks already undertaken and to encourage
3 them to continue to invest in expansions of the Kern River system. It would be
4 particularly troubling if, on the heels of Kern River's \$1.3 billion of expansion
5 project investments and significant realized credit risks, the Commission in this
6 case established a return on equity below the reasonable expectations of Kern
7 River's equity investors. Such an outcome essentially would disregard the risks
8 taken by Kern River's equity holders and would amount to an unfair "bait and
9 switch" that would threaten to chill investment not only by MEHC, but also
10 throughout the entire pipeline industry. This would have a negative impact on
11 needed new pipeline infrastructure in the United States.

12 **Q.** Does this conclude your prepared direct testimony?

13 **A.** Yes.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Kern River Gas Transmission Company) Docket No. RP04-___-000

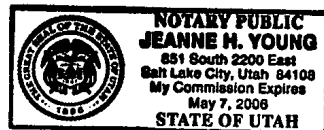
STATE OF UTAH)
 : ss
COUNTY OF SALT LAKE)

AFFIDAVIT OF JOHN R. SMITH

John R. Smith being first duly sworn, on oath states that he is the witness whose testimony appears on the preceding pages entitled "Prepared Direct Testimony of John R. Smith"; that, if asked the same questions that appear in the text of said direct testimony, he would give the answers that are herein set forth; and that affiant adopts the aforesaid testimony as his sworn, direct testimony in this proceeding.

John R. Smith
John R. Smith

SUBSCRIBED AND SWORN TO before me, a Notary Public in and for the State of Utah, this 21st day of April, 2004.



Jeanne H. Young
Notary Public

Kern River Gas Transmission Company
Aggregate Net Income vs. Additional Equity Investments 1992 -2003
(Dollars in Thousands)

Kern River Income

	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	Total
Net Income	\$ 34,099	\$ 42,066	\$ 38,142	\$ 37,998	\$ 44,760	\$ 42,620	\$ 40,682	\$ 32,184	\$ 38,049	\$ 38,051	\$ 46,225	\$82,814	\$ 517,690

Additional Equity Investments (since 1992)

	Gross Plant	Equity Investment
Non-Expansion Capital Expenditures 1992-2003	\$34,614	\$11,077
2002 Expansion	\$79,604	\$23,881
2003 Expansion	\$1,211,789	\$375,655
High Desert Lateral	\$29,509	\$8,853
Big Horn Lateral	\$3,611	\$3,611
Total	\$1,359,127	
 Total Equity Contributions Since Original System Investment		\$423,077
 Percent of Net Income Reinvested in Facilities 1992- 2003		81.724%