UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

PREPARED DIRECT TESTIMONY
OF
MARTIN J. HANSEN
ON BEHALF OF
KERN RIVER GAS TRANSMISSION COMPANY

Q. Please provide your name, title and business address.

A. My name is Martin J. Hansen. I am employed by Kern River Gas Transmission Company ("Kern River" or "Company") as a Staff Analyst in the Rates Department. My business address is 2755 East Cottonwood Parkway, Suite 300, Salt Lake City, Utah 84121.

Q. Please summarize your educational and employment history.

A. I received a B.S. degree in accounting from the University of Utah in 1974. I was employed as an accountant with the CPA firm of Hansen, Trevors & Associates for two years early in my career. For more than 27 years, I have been involved in the natural gas pipeline business. I worked as a cost analyst and a senior cost analyst in the Engineering department at Northwest Pipeline Corporation for ten years. In 1987, I joined the Rates Department of Northwest Pipeline Corporation ("Northwest"), a subsidiary of The Williams Companies, Inc., as a rate analyst. I helped prepare Northwest's general rate filings in Docket Nos. RP88-47, RP91-166, RP93-5, RP95-409 and RP96-367. After Williams acquired 100%

ownership of Kern River from Tenneco, my responsibilities included all rate filings and rate studies for Kern River and Northwest. I assisted in the preparation and settlement of Kern River's Docket No. RP99-274 rate filing. Since that time, I have assisted with various Kern River rate matters, such as the extended term ("ET") rate settlement, the California Action Project, and the 2002 and 2003 Expansions.

Q. Please describe your current responsibilities.

A. In my current position, I am responsible for preparation of Kern River's rate filings and expansion studies before the Federal Energy Regulatory Commission ("FERC" or "Commission"). I contribute to the Company's strategic and annual plans by developing regulatory strategies and necessary rate studies. I monitor regulatory proceedings of other companies as their proceedings may affect Kern River's business.

Q. What is the purpose of your prepared direct testimony?

A. My testimony provides support for Kern River's general section 4 rate change filing, including the company's overall cost of service and the various statements and schedules related thereto. I also describe the rate base adjustments Kern River has made in this filing.

Q. Please identify the statements and schedules you are supporting.

A. I will describe and, where appropriate, explain the following items included in Kern River's rate filing:

Statement A	Overall Cost of Service and Incremental Cost of Service
Statement A-1	Incremental Projects Cost of Service

Statement A-2	Cost of Service - General Items
Statement A-3	Cost of Service – Compressor Engines
Statement B	Rate Base and Return Allowance - Overall Summary and Incremental Projects Summary
Statement B-1	Rate Base and Return Allowance - Incremental Projects (Exclusive of General Items)
Statement B-2	Rate Base and Return Allowance for General Plant
Statement B-3	Rate Base and Return Allowance for Compressor Engine
Statement C	Cost of Plant
Schedule C-1	Gas Plant by Account
Schedule C-2	Gas Plant Additions Claimed in Rate Base
Statement D	Accumulated Provision for Book and Regulatory Depreciation, Depletion, and Amortization
Statement E	Working Capital
Schedule E-2	Materials and Supplies and Prepayments
Statement H-1 and H-1 ADJ	Operation and Maintenance Expenses and Adjustments
Schedule H-1 (1) (a)	Labor Costs
Schedule H-1 (1) (b)	Materials and Other Expenses Exclusive of Gas Costs
Schedule H-1 (1) (c)	Expenses Applicable to Accounts 810 and 812
Schedule H-1 (2) and Schedules H-1 (2) (a) through (k)	Details of O&M Accounts
Schedule I-1 (a)	Cost of Service–Original System & 2002 Expansion
Schedule I-1 (b)	Cost of Service by Incremental Facility
Schedule I-1 (d)	Basis of Allocation of Common and General Costs

Schedule I-2 Classification of Transmission Costs

These statements and schedules are submitted in compliance with Section 154.312 of the Commission's regulations and have been adapted to conform to Kern River's levelized rate methodologies.

Q. How do these statements and schedules relate to the rates proposed in Kern River's filing?

A. Certain of the statements and schedules and related workpapers that I am sponsoring depict Kern River's current updated rate base and cost of service items at a snapshot in time, i.e., on October 31, 2004, the end of the test period used in the rate filing. The data in those statements and schedules serve as the starting point for Kern River's levelization computations. The levelization computations require forecasts of future costs of service for the various periods over the remainder of the shippers' contract terms. Therefore, other statements and schedules included in Kern River's filing present the results of the levelization or other cost of service calculations. The models used to derive Kern River's rates are shown in various pages in Schedule J-2, as explained by Mr. Bruce Warner in his prepared direct testimony. Mr. Warner explains the levelization aspects of the models in his testimony.

Q. Please describe the statements and schedules in more detail.

A. Kern River has supplied more details within certain statements and schedules than are required by the regulations in order to illustrate costs that are directly billed and costs that are allocated among the various services. This additional detail is helpful due to the emergence of three important, incrementally priced projects that have been completed since Kern River's last general rate proceeding, i.e., the 2003 Expansion, the High Desert Lateral and the Big Horn Lateral. Mr. Darrell Swensen provides additional information pertaining to Kern River's direct billing and cost allocation procedures in his prepared direct testimony.

For example, Statements A and B (including Statements A, A-1, B and B-1) contain information about directly charged transmission Operation and Maintenance ("O&M") expenses and rate base, directly charged Administrative and General ("A&G") expenses, and A&G allocated among the services based on the FERC-accepted KN methodology for allocating indirect A&G costs. The allocation of A&G costs using the KN methodology is shown in Schedule I-1(a) at page 4 and I-1(b) at page 4**.** In addition, those statements contain details about cost of service and the rate base related to general items that are allocated to the various services, because they benefit the entire system. See particularly Statements A-2 and B-2. See Schedule I-1(d) for the methodologies used to allocate various rate base and expense items in deriving rate base and cost of service.

Q. Please explain how the statements and schedules relate to Kern River's rolled-in and incrementally priced services.

A. Where applicable, the statements and schedules I describe separately detail cost of service and rate base information pertaining to the Rolled-In System (the Original System plus the 2002 Expansion) and each of the three incrementally priced projects. This is because the Commission's preliminary determination order in Docket No. CP01-422-000 (98 FERC ¶61,205) required that rates for the 2003

Expansion be developed under the guidelines of the Commission's September 15, 1999, Policy Statement for Certification of New Interstate Natural Gas Pipeline Facilities (88 FERC ¶ 61,227). Under that Policy Statement, "the threshold requirement for existing pipelines proposing new projects is that the pipeline must be prepared to financially support the project without relying on subsidization from existing customers." *Id.* at 61,714. The same principle applies to the other two incremental projects as well.

Q. What is the source of the rate of return calculations, shown on Statements B, B-1, B-2 and B-3?

A. Mr. Swensen's prepared testimony explains Statements F-2 through F-3, which provide the particulars of the computations of the return shown on Statements B, B-1, B-2 and B-3. Mr. Warner explains in his testimony why Kern River proposes to use the same cost of debt for the incremental projects and the Rolled-in System.

Q. Please explain Statement C and Schedules C-1 and C-2.

A. Statement C is a summary of the total cost of plant, as well as property additions and retirement activity, for the base period (twelve months ended January 31, 2004), plus contemplated property additions during the adjustment period ending October 31, 2004.

Schedule C-1 presents Kern River's base period and adjusted gross plant balances by FERC account for the Original System, the 2002 Expansion, the incremental facilities and for joint transmission, general and intangible plant.

Schedule C-2 presents details pertaining to construction work in progress (CWIP) and Account 106 balances and 2004 budgeted capital items that Kern

River anticipates will be in service by October 31, 2004, and which are included in the rate base. Kern River has set up a new account on its books for Joint Transmission Plant. These are facilities that benefit and are allocated to both the Rolled-In System and the 2003 Expansion. This schedule also presents the estimated final cost for the 2003 Expansion of $1.193 billion.

Q. What information is depicted on Statement D?

A. Statement D contains details about accumulated depreciation and amortization for each component of Kern River's plant both per books as of January 31, 2004, and as adjusted for rate purposes.

Q. How are Kern River's accumulated depreciation and amortization balances affected by Kern River's rate levelization?

A. Due to the levelization process that Kern River uses for levelized projects, Kern River's accumulated book depreciation and amortization balances are not directly relevant to the derivation of rates where the relevant plant is included in the levelization. Instead, the adjusted accumulated depreciation and amortization balances used for rate purposes reflect the accumulation of depreciation and amortization expenses reflected in the derivation of Kern River's past rates. Those balances also reflect the net cost of removal ($1,466,500) for property that has been retired, i.e., cost of removal less salvage received.

The adjusted balances of accumulated depreciation and amortization as of October 31, 2004, for rate purposes are the starting points for determining the total amount of additional investment that must be recovered over the remainder of each levelization period. A comparison is made to ensure that the total amount to be recovered (both in past rates and future rates) does not exceed the intended final target balance of accumulated depreciation and amortization for rate purposes. For example, the total investment recovery is scheduled to be 70 percent of the original investment for the Rolled-in System and the 2003 Expansion during their respective levelized rate periods. The adjusted balances of accumulated depreciation and amortization for rate purposes for the High Desert Lateral reflects straight line depreciation from the in-service date, consistent with the traditional declining rate base methodology used to design the recourse rates for that project. Book and regulatory depreciation expense are the same for the High Desert Lateral. For presentation purposes, the Adjusted Regulatory Balance on Statement D column (h) for the Original System, 2003 Expansion and the 2002 Expansion are from the first-year average accumulated depreciation from the levelized models.

Q. Mr. Edward Feinstein's direct testimony discusses the determination of regulatory depreciation reserves for compressor engines and general plant. What steps has Kern River taken to ensure that its October 31, 2004, regulatory depreciation reserves in total will be properly stated?

A. Kern River has adjusted its transmission depreciation reserves to offset the adjustments to the reserves for general plant and compressor engines. The adjustment process involved four steps:

- Kern River accumulated its regulatory accumulated depreciation of transmission plant from inception through October 31, 2004, from the models that support its previously approved and currently effective and approved costs of service.

- Using Mr. Feinstein's recommended balances of accumulated regulatory depreciation for general plant and compressor engines, Kern River reclassified the appropriate portions of the total, inception-to-date accumulated regulatory depreciation reserve for transmission plant to the reserves for general plant and compressor engine plant. After this step, the total regulatory depreciation reserve was unchanged, but the reserve was segregated into three categories: transmission, general and compressor engines. The adjustments to establish the accumulated depreciation balances for general plant and compressor engines were debits reflecting the under-depreciated status of those plant categories, and the adjustments to the transmission reserve were credits, thereby reducing the amount of future depreciation to be taken on transmission plant.
- Kern River then established the regulatory assets for general plant and compressor engines plant that Mr. Feinstein recommends. At the same time, equal and offsetting credits to the accumulated regulatory reserves for depreciation of general plant and compressor engines plant were recorded in the rate models. These adjustments did not change rate base at October 31, 2004, but made the regulatory reserves for depreciation of those categories of plant equal to the correct book and rate reserves for depreciation that result from Mr. Feinstein's recommendations.
- As the final step, the amortization amounts related to the regulatory assets for general plant and compressor engines plant were calculated and allocated to each of Kern River's services. The regulatory asset balances were allocated to

each service based on the aggregate MDQs of each group of shippers. The annual amortization amounts were then determined by dividing the allocated regulatory asset balances by the remainder of the lives of the existing shipper contracts. In summary, these calculations establish and amortize the regulatory assets over the lives of shippers' contracts and do not change rate base as of October 31, 2004.

Q. Please describe Statement E and Schedule E-2.

A. Statement E and Schedule E-2 set forth the summary and details of the working capital items included in rate base. The prepaid expense balance reflects the thirteen-month average as of January 31, 2004. The as adjusted balance of materials and supplies was calculated from the January, 2004 actual balance, which is representative of the monthly amounts going forward. The balance has been adjusted upward, primarily due to transferring a spare compressor engine from capital to inventory and to recording items in inventory which were previously expensed in error.

Q. Please summarize Kern River's proposed rate base adjustments.

A. The following is a list of the adjustments Kern River has made to rate base that are listed on various schedules included with the rate filing:

- An adjustment of ($8.6 million) was made to intangible plant. Most of this adjustment ($8 million) is related to a contribution-in-aid of construction paid to Southwest Gas to help fund the Blue Diamond delivery point to facilitate deliveries into the Southwest Gas market. The adjustment reflects reclassification of this plant to transmission plant for cost-of-service calculation purposes, to be levelized and recovered along with the Original

System transmission plant, since the asset has a life similar to that of the transmission system. The other $.6 million relates to a contribution-in-aid of construction for the High Desert Lateral and has been included in the cost of facilities to determine the recourse rate applicable to those facilities.

- Compressor engines of $21,341,848 for the Rolled-in System and $35,770,028 for the 2003 Expansion were reclassified from transmission plant to transmission compressor engines to identify the appropriate amounts for application of the proposed depreciation rate for compressor engines, as described in Mr. Edward Feinstein's testimony. This reclassification is for purposes of this rate presentation only; the engines remain part of transmission plant and their costs are assigned to the Rolled-in System and to the 2003 Expansion as appropriate.
- The 2003 Expansion investment from the base period was increased to reflect additional capital investment activity during the test period and to agree with the total project estimate (including AFUDC and overheads) of $1.193 billion. In addition, the 2003 Expansion Project cost was increased by $3.5 million to reflect an allocated share of the cost of Joint Transmission plant additions between February 1, 2004, and October 31, 2004, which benefit both the Rolled-in System and the 2003 Expansion.
- Projected additions to transmission gas plant of $14.1 million were added to the Original System to reflect capital projects anticipated to be completed during the test period (February 1, 2004 to October 31, 2004).

- Plant additions of $3.0 million for the same period were added to general plant. This is primarily for software enhancements expected to be completed within the test period.
- The accumulated depreciation and amortization amounts are derived from the results of the levelization models. The adjustment shown in Statement D, column (g) is the difference between the base period book and levelized depreciation amounts as of the end of the test period. For the High Desert Lateral, Transmission Compressor Engines and General Plant, the adjustment is to record straight-line depreciation through October 31, 2004, because for book and rate purposes, straight-line depreciation is proposed herein.
- For working capital, an adjustment of $4,680,123 was made to correct the proper level of material and supplies inventory expected at October 31, 2004.

Q. Please summarize Kern River's proposed treatment of O&M and A&G costs, as reflected in the rate filing.

A. The H-1 statements and schedules listed above provide the details behind Kern River's rate filing regarding O&M and A&G costs for the twelve months ended January 31, 2004, as adjusted through October 31, 2004, for known and measurable changes. The statements and schedules show the monthly actual activity in the O&M and A&G accounts during the base period used herein (the twelve months ended January 31, 2004). Details are provided for total expenses, labor costs, material and other costs, as well as for the gas costs in Accounts 810 and 854. In addition to total company information, Kern River has provided the same information for the Rolled-In System and each of the incremental projects.

Mr. Swensen explains the procedures used to bill costs to the appropriate project in his direct testimony.

Q. What test period adjustments does Kern River propose to O&M and A&G costs?

A. Each of the O&M and A&G cost adjustments is summarized on Statement H-1 ADJ in Kern River's filing.

Adjustment No. 1 eliminates the effect of fuel surcharge reimbursement-related costs because all fuel costs are recovered in-kind separately via the fuel reimbursement mechanism. The adjustment removes $38,388,099 of costs from Account Nos. 810 and 854 related to gas compressor fuel.

Adjustment No. 2 reverses out-of-period, one-time amounts credited to expense during the base period related to a settlement with Nevada Power regarding the Enron bankruptcy. The adjustment eliminates abnormal credits to expense of $669,415 in Account Nos. 904.

Adjustment Nos. 3 and 4 eliminate the ACA and GRI surcharges of $752,418 and $2,956,332, respectively. Those costs are collected as a surcharge under the tariff and are not subject to review in this rate proceeding.

Adjustment No. 5 increases the group life and medical insurance in Account No. 926 by $207,024 to reflect cost levels projected for the twelve months ended October 31, 2004.

Adjustment Nos. 6 and 20 decrease the pension expense by $58,149 and increase the post-retirement benefits other than pension (PBOP) expenses in Account No. 926 by $263,062 to agree with the most recent actuarial reports for these employee benefits. The claimed expense includes an adjustment for the projected PBOP regulatory asset of $190,759 (amortized over three years, the term that the new rates are assumed to remain in effect). The origin of this regulatory asset is explained later in my testimony.

Adjustment No. 7 increases Account No. 850 by $85,700 for the costs of air quality testing that are not part of the base period costs. Kern River's engineering department estimated the relevant costs for each affected facility.

Adjustment Nos. 8, 9, 12, and 23 are labor adjustments. Adjustments 8, 9 and 12 are made to annualize both direct and A&G labor costs associated with the 2003 Expansion, Big Horn and High Desert and to bill labor appropriately between the Rolled-in System and the expansion projects. The net effect of these adjustments is zero. Adjustment No. 23 is to adjust labor costs to levels projected to be in effect at the end of the test period. The projections take into account known and measurable changes in the employee staffing level and the 2004 pay raise for employees. Kern River considered the O&M spending levels and the capital spending levels for the last six months of the base period and used these representative percentages to derive the appropriate O&M cost level. A percentage of costs between direct O&M and A&G costs was derived based on the last six months of actual costs. The total projected labor was split between direct O&M and A&G costs accordingly. The average percentage of costs split to capital and O&M accounts, based on the last six months of actual costs, was used to project the labor amounts for both the direct O&M and the A&G labor amounts. The capitalization percentage used for A&G labor is 6.92% and the capital percentage for direct O&M labor is 17.29%. Based on these projections, payroll loading and other labor costs were adjusted appropriately between capital and O&M. This adjustment is necessary due to the completion of the 2003

Expansion since more labor is being charged to O&M since the completion of the 2003 Expansion.

Adjustment Nos. 10 and 11 are materials and other adjustments made to annualize costs related to the incremental projects, with an offsetting credit to adjust the costs of the Rolled-In System. Adjustment No. 10 also reflects additional field material costs of $1,903,811 due to the 2003 Expansion project. The first three months of the base period costs, exclusive of fuel, prior to the 2003 Expansion in-service were annualized to determine the appropriate total for the Rolled-In System for total direct maintenance expenses.

Adjustment No. 13 increases expenses in Account No. 923 by $142,732 to amortize expected outside legal fees related to the rate proceeding over a three-year period.

Adjustment No. 14 is to adjust credits out of "expenses transferred" in Account No. 922 related to costs formerly charged to the 2003 Expansion by Kern River's information services and human resources departments. With the reduction of construction activity that has occurred, the ongoing costs of those departments will be expensed. An adjustment was also made to correct the payroll loading and paid time off amounts that are charged to capital projects going forward.

Adjustment No. 15 is to adjust rents for the cost of the company's new headquarters building lease. A reduction of $712,128 was made to Account No. 931. The new building lease expense amount is $874,279 annually.

Adjustment Nos. 16, 17 and 22 increase various O&M accounts (Account Nos. 853, 864, 865 & 856) by $403,680. Materials and parts were credited to

O&M accounts and transferred to inventory during the base period. This was to correct for items expensed in error. These one-time adjustments for inventory were eliminated to normalize the direct operation and maintenance expenses.

Adjustment No. 18 eliminates trustee fees in the amount of $44,362 from Account No. 923 since such costs are included in the cost of debt, as discussed in Mr. Swensen's testimony.

Adjustment No. 19 for $252,298 adjusts paid time off ("PTO") and charges to construction to Account No. 926 based on the projected labor expenses.

Adjustment No. 21 adjusts Account 920 for material by $2,440 to reflect a zero balance. Account 920 should only reflect labor charges and should not have anything coded to material.

Adjustment No. 24 adjusts for a one-time credit in the September 2003 actuals of $185,951 in Account No. 850. This credit was for the one-time sale of a home due to an employee relocation and the costs have been adjusted to reflect normal, ongoing expenses.

Q. Does Kern River's rate filing reflect application of Statement of Financial Accounting Standard ("SFAS") No. 106?

A. Yes. Kern River has applied SFAS No. 106 for accounting purposes and rate recovery. In Kern River's last general rate settlement in Docket No. RP99-274, the parties agreed upon rate and accounting procedures to provide for the costs of post-retirement benefits other than pensions ("PBOP") (post-retirement medical). As described in Article II, Section 2, of the Docket No. RP99-274 settlement, the settlement cost of service included $433,526 per year associated with the recovery of PBOP costs. Kern River agreed to contribute this amount on at least a quarterly basis into external trusts for the future benefit of Kern River's employees.

To the extent that actuarially determined PBOP amounts differ from the amounts contributed to the trusts, the settlement provided that Kern River would record a regulatory asset or liability for the differences, which would then be deferred until Kern River's next rate case. At that time, the regulatory asset or liability is to be amortized and reflected in future rates. The RP99-274 settlement provided that Kern River is entitled to file to reflect this regulatory asset or liability, if any, without regard to whether such costs were known, incurred in, or related to any period prior to the base or test periods of such general rate filings, as specified in Part 154 of the Commission's regulations. It is my understanding that the intent of this provision was to permit Kern River fully to true-up amounts accrued to amounts funded and recovered in rates over the life of the post-retirement benefit plans.

Q. Does Kern River's current filing reflect a PBOP adjustment?

A. Yes. The cost of service proposed in Kern River's current rate filing reflects a PBOP true-up adjustment (Adjustment No. 20) of $63,586. This amount equals $190,759 divided by three years, in order to amortize the projected October 31, 2004 accumulated regulatory PBOP asset into rates over the period that the new rates are expected to remain in effect. This item increases Kern River's claimed expenses. The average balance of this item is also included in rate base for the applicable years. The PBOP expense level reflected in this filing is based on the current benefits plan and costs related thereto. Kern River has been informed by

MEHC that a change to the plan may be made which could alter the costs as adjusted in these test period adjustments, though the change is not "known and measurable" at this time. Kern River expects MEHC to make decision on the potential plan amendment during the test period, and if a change is approved, Kern River will include any known and measurable effects of the amendment in updated cost levels for the test period, as appropriate.

Q. Please provide an overview of Kern River's proposed cost allocation and cost classifications, as reflected in the rate filing.

A. Schedule I-1(a) contains the Original System and 2002 Expansion costs of service, and is presented for the transmission function only, since Kern River does not have storage. The schedules in the Statement I-1(b) series detail costs of service and rate bases for the 2003 Expansion, the High Desert Lateral and the Big Horn Lateral. Kern River provides the firm High Desert Lateral service at a negotiated rate. Kern River has allocated an appropriate allocation of costs to that incrementally priced service in the recourse rate. Since Kern River is not proposing zoned rates, Schedule I-1(c) is not applicable. Schedule I-1(d) allocates various rate base and expense general items in deriving rates to the incremental facilities and the Rolled-In System based on either gas plant or labor percentages.

Schedule I-2 presents the classification of Kern River's costs between those that are fixed and those that are variable. Kern River has applied its understanding of FERC precedents in classifying the materials and supplies portion of Account Nos. 853 and 864 as variable.

Q. Does this conclude your prepared direct testimony?

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 MARTIN J. HANSEN

Martin J. Hansen, being first duly sworn, on oath states that he is the witness whose testimony appears on the preceding pages entitled "Prepared Direct Testimony of Martin J. Hansen"; 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.

Martin J. Hansen

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

NOTARY PUBLIC
JEANNE H. YOUNG
651 South 2200 East
Salt Lake City, Utah 84108
My Commission Expires
May 7, 2008
STATE OF UTAH

Jeanne H. Young
Notary Public