SOUTHWEST GAS CORPORATION

2004

March 12, 2004

Docket Control Center
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

MAR 12 2004

Southwest herewith submits an original and thirteen (13) copies of an Application for Pre-Approval of Cost Recovery for Participation in the Silver Canyon Pipeline Project, which has been redacted due to the commercially-sensitive nature of the information contained in the filing.

By copy of this letter, Southwest is providing an unredacted copy of the filing to the Director of the Arizona Corporation Commission Utilities Division. The unredacted filing is being provided under seal in reliance on the confidentiality afforded by A.R.S. § 40-204.C.

Respectfully,

Randall W. Sable

Randall W. Sable
Manager, State Regulatory Affairs

c Ernest Johnson, ACC

5241 Spring Mountain Road / P.O. Box 98510 / Las Vegas, Nevada 89193-8510 / (702) 876-7011

SOUTHWEST GAS CORPORATION

March 12, 2004

Arizona Corporation Commission
Attention: Docket Control
1200 West Washington Street
Phoenix, Arizona 85007

Re: **Application for Pre-Approval of Cost Recovery for Participation in the Silver Canyon Pipeline Project**

Dear Commissioners:

For the reasons that follow, Southwest Gas Corporation ("Southwest") respectfully applies for Commission pre-approval of the cost recovery proposed in this filing. Portions of this filing are redacted due to the proprietary and commercially-sensitive nature of the information. The redacted information will be provided to Staff pursuant to the terms of a confidentiality agreement.

<u>Background and Purpose</u>
The Commission, on December 18, 2003, issued its Policy Statement Regarding New Natural Gas Pipeline and Storage Costs. In that policy, the Commission determined that the need for the development of new gas infrastructure in Arizona was essential to adequately serve the growing energy needs of the State of Arizona. In fact, the Commission's recognition of the current need warranted considering pre-approving cost recovery for utilities and the adoption of alternative cost recovery methods. Pursuant to this policy statement, Southwest files this application for pre-approval of its cost recovery related to its participation in the Silver Canyon Pipeline project ("Silver Canyon"). Southwest proposes to recover these costs through the existing Purchase Gas Adjustment Provision ("PGA") mechanism. Southwest believes the facts and circumstances outlined in this application support the Commission's pre-approval of cost recovery by demonstrating that Southwest's participation in this infrastructure project will accomplish several of the objectives specified in the policy statement.

In an effort to address the Commission's desire for additional infrastructure and to meet the future needs of Southwest's growing customer base, Southwest has expressed interest in a number of proposed interstate pipeline and market area storage projects. One such project is the Silver Canyon Pipeline proposed by Kinder Morgan Energy Partners. As proposed, the pipeline would run roughly east to west from Window Rock, Arizona to the California border near Ehrenberg. If constructed, the pipeline would bring additional supplies from the San Juan Basin and Rocky Mountain production areas to the [redacted] city gates. The Silver Canyon project contributes to: 1) accomplishing the Commission's general objective to secure additional natural gas infrastructure and supply diversity for Arizona; and 2) Southwest's need for additional pipeline capacity to accommodate future customer growth.

General Description of Project

The Silver Canyon Project will include a high-pressure interstate natural gas pipeline system that is intended to extend from the Blanco Hub area in San Juan County, New Mexico, continuing south and west to various points located in the Phoenix area and then to points along the Arizona/California border near Ehrenberg, Arizona. The pipeline is planned to have capacity of 750,000 Dth per day or more, with access to gas located in the San Juan and Rocky Mountain producing basins. Various points of delivery and interconnection along the pipeline's route are planned including connections to a proposed storage project in Arizona, interconnections with Southern California Gas Company and North Baja Pipeline at the Arizona/California Border, as well as one or more interconnection with the El Paso Pipeline system ("El Paso").

On January 9, 2004, Southwest entered into a Precedent Agreement ("Agreement") with Silver Canyon which establishes the conditions and prerequisites for Southwest to ultimately acquire firm capacity rights on the proposed pipeline. Southwest's contracted receipt point is the Blanco area of the San Juan Basin. A copy of the Agreement, which is considered confidential and commercially-sensitive by the parties, is attached hereto as "Exhibit A".

Southwest plans for its interstate pipeline capacity needs on a long-term basis. New capacity purchases are typically planned to cover growth for at least three to five years in resource-limited markets. When possible, and economically beneficial to ratepayers, contracts are structured to provide quantity increases year-to-year to match projected growth trends. This allows Southwest to minimize costs for unused capacity and precludes the need to make frequent incremental capacity purchases. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Silver Canyon offers enhanced services which will provide flexibility to meet intraday peak demands. [redacted] Historically, Southwest's service from El Paso has accommodated these peak demands. Recently however, El Paso has stated that it may no longer be able to allow historically traditional intraday flexibility due to the increasing loads on its system. [redacted]

Time Line

Southwest respectfully requests a final decision from the Commission within 90 days of this filing to allow the project to proceed expeditiously and meet the proposed completion date of July 2006. Silver Canyon has put forth the following project time line:

• FERC submittal	Fourth Quarter 2004
• Begin construction	Fourth Quarter 2005
• Commence operation	Third Quarter 2006

Discussion

Although there is no way to guarantee the behavior of future prices, in the past several years gas from the San Juan Basin in southwest New Mexico has been less expensive than gas from the west Texas, Permian Basin. Because of its lower cost, Southwest endeavors to purchase as much San Juan gas as possible to meet customer demands but has been limited because of limited San Juan pipeline capacity on the El Paso system. El Paso's system is primarily designed to flow east to west with termination points at the California border. In order to bring supplies from El Paso's northern mainline to markets in central and southern Arizona, El Paso relies on three north-to-south crossover lines. As demand for San Juan gas has increased in Arizona and Southern California, these crossover lines have become congested, making it more difficult to access the San Juan market. Silver Canyon is designed to bring gas from San Juan directly to central Arizona. Service from Silver Canyon would lessen Southwest's dependence on El Paso and provide additional direct access to San Juan supplies and indirect access to Rocky Mountain supplies.

Currently, (with a very minor exception in western Arizona) nearly all interstate pipeline service to Southwest's Arizona system is provided by El Paso. Historically, as a Full Requirements customer on El Paso, capacity growth was intrinsic to the service level and negotiated annual revenues such as those most recently set forth in the 1996 settlement. As part of the FERC mandated September 2003 conversion to Contract Demand (FERC Docket RP00-336), Southwest was allocated specific capacity rights on El Paso. These capacity rights are defined by receipt and delivery point combinations, and Southwest will have to purchase additional interstate capacity as customer demands exceed these rights. The new interstate capacity rights set forth in the Agreement with Silver Canyon will be incremental to Southwest's rights on El Paso.

In Arizona, Southwest is almost totally dependent on the existing El Paso system to transport gas to its distribution system. It would be difficult and very costly for a new pipeline to duplicate any but a very few of the many interconnections between

El Paso and Southwest's distribution system. This is further exacerbated by the tremendous development that has occurred since El Paso built most of its facilities. Any new pipelines that wish to interconnect with, and provide significant volumes to, Southwest's distribution system must either connect with El Paso and secure a "short haul" service or build new pipelines through developed areas.

Customer demand has increased with the population growth in Arizona and is expected to continue increasing for the foreseeable future. Current contract(s) with El Paso are expected to provide sufficient capacity only through the winter of 2005/06. However, during the CD conversion, Southwest was allocated San Juan capacity with primary delivery rights to Topock. This capacity can not deliver supplies to Arizona on a primary basis. These volumes are noted in Chart 1 and Table 1 for reference. [redacted]

Table 1 - Arizona Interstate Pipeline Capacity Requirements (February)
Net Dth per Day at City Gate

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Demand[1]	647,934	663,747	679,946	696,541	713,540	730,955	748,794
El Paso [2]	640,431	640,431	640,431	640,431	640,431	640,431	640,431
Minimum to be acquired	7,503	23,316	39,515	56,110	73,109	90,524	108,363
[redacted]							
Topock [4]	90,407	90,407	90,407	90,407	90,407	90,407	90,407

[1] Demand based on long range forecast designed peak day. Excludes SPA customers.
[2] Capacity under contract from El Paso Pipeline, including capacity that has primary delivery rights to Topock (California zone).
[redacted]
[4] Contracted El Paso capacity that has primary delivery rights to Topock (California zone).

Service from El Paso was used as the economic benchmark for evaluating Silver Canyon. In order to make a comparison with Silver Canyon, certain key assumptions were made regarding El Paso's rates in 2006. El Paso is expected to file a rate case in 2005 to coincide with the end of the ten-year period defined in the 1996 El Paso settlement. [redacted]

[redacted] A summary of the most likely cost scenarios is included as "Exhibit B".

Evaluation Standard

All infrastructure projects, including pipelines and storage should be evaluated by the Commission based on the likelihood of achieving the maximum value for the customer. The definition of value should not be limited to the "bottom-line" cost of the project, but rather should be measured by a full spectrum of metrics to include diversity of source, diversity of service providers, reliability and flexibility, as well as cost. Southwest believes the Silver Canyon project addresses each of these criteria and demonstrates significant value for its customers as follows:

- As an alternative to taking incremental service on the existing infrastructure, and a means by which to deliver additional supplies from the San Juan Basin and possibly the Rocky Mountain Basin, the project provides diversity in the form of additional access to San Juan supply and a second major player in the capacity market.
- New pipelines typically have very long service lives of at least 60 years. Silver Canyon should be able to provide reliable service for decades. In addition, the project should aid in facilitating growth, particularly in the areas north and west of Phoenix.
- [redacted]
- Capacity greater than design day requirements will help to minimize price volatility by ensuring adequate supply deliverability.

Attention should also be given to how the project owners are willing to work with customers and regulators to balance any environmental impacts with the need to build new infrastructure to facilitate growth and generate profits. As members of the Arizona community, the project owners should be good corporate citizens and partners with the state and local populations and must comply with FERC regulations and Office of Pipeline Safety audits and rules.

Recommended Cost/Rate Recovery and Mechanism

Southwest will be required to pay Silver Canyon [redacted]

[redacted] The estimated fixed cost to Southwest will range from approximately [redacted] million annually beginning the winter season of 2006/07 to a maximum of approximately [redacted] million beginning the winter season of 2010/11 and extending until the end of the agreement in 2014/15. Southwest will begin incurring the reservation charges from Silver Canyon after the completion of pipeline construction in 2006.

For Southwest's Arizona service area, the total cost of capacity and gas supplies for the 2002/03 gas year was approximately $243.4 million. Based on the estimated 2005/06 reservation cost of [redacted] million, the addition of Silver Canyon represents an overall gas cost increase of approximately [redacted] percent. As demand for gas increases in Arizona, and assuming gas costs remain at current levels, the cost for Silver Canyon capacity would represent a diminishing portion of the overall supply portfolio.

The cost of current interstate pipeline capacity charges are recovered from Southwest's customers through its PGA mechanism, which Southwest files monthly with the Commission Staff. The mechanism is adjusted monthly to reflect the most recent 12-month rolling average of gas costs, subject to a floor and ceiling that limit the change in any one month. The cost of the additional capacity acquired from Silver Canyon should be afforded the same treatment as the cost of the existing capacity. The costs should be recovered contemporaneously with their incurrence, through the monthly PGA mechanism, or whatever mechanism the Commission may ultimately utilize to replace the monthly PGA mechanism. The use of the existing PGA mechanism will not require the development and implementation of any new ratemaking methodology or mechanism.

<u>Impact on Customers</u>
For the 12-month period ended December 2003, Southwest's sales volume was approximately 600 million therms. Recovery of the [redacted] million in reservation charges for Silver Canyon over this sales volume would increase Southwest's gas cost rate by less that one cent per therm ([redacted] million divided by 600 million therms = [redacted]therm). A residential customer that consumes the average of 330 therms annually would pay an additional [redacted] per year for Silver Canyon capacity.

<u>Conclusion and Requested Commission Action</u>
Southwest has conditionally contracted with Silver Canyon for additional capacity to meet the growing demand for natural gas in the State of Arizona and to diversify its interstate pipeline suppliers. The agreement with Silver Canyon will lessen Southwest's dependence on the El Paso pipeline system and provide Southwest, and its customers, additional access to what has been lower-cost gas supplies from the San Juan Basin in New Mexico. Southwest believes this agreement benefits its customers and the State of Arizona. Southwest's action to obtain additional capacity and to diversify its supply options was a result of reasoned and thoughtful judgment that balanced the cost of the acquisition with the benefits to be derived from it. As a

result, the Agreement between Southwest and Silver Canyon, and the costs related thereto, should be deemed reasonable and prudent by the Commission. Pursuant to the Commission's Policy Statement regarding New Natural Gas Pipeline and Storage Costs, Southwest respectfully requests the Commission to pre-approve recovery of these costs from its customers through its existing PGA mechanism.

Respectfully,

Thomas J Armstrong
Vice President/Gas Resources & Energy Services

feh
c Ernest J. Johnson

Attachments

PRECEDENT AGREEMENT
Between
Silver Canyon Pipeline LLC
And
Southwest Gas Corporation

This Precedent Agreement dated this 9th day of January, 2004, states an agreement between Silver Canyon Pipeline LLC ("Silver Canyon"), a Delaware limited liability company owned by Kinder Morgan Energy Partners, L.P. ("KMP"), and Southwest Gas Corporation ("Shipper").

Silver Canyon and Shipper hereby agree to enter into a firm natural gas transportation agreement ("Enhanced Firm Transportation Service Agreement") for the services described herein, provided the conditions set forth in this Precedent Agreement and the Appendix A attached hereto are met in accordance herewith. The commitment provided by Shipper via this Precedent Agreement and the Appendix A attached hereto and potentially other similar agreements will be used as support for the construction and operation of pipeline facilities designed to meet Shipper's requirements for firm natural gas transportation service. Accordingly, Silver Canyon and Shipper agree to the following:

RECITALS:

WHEREAS, the Silver Canyon Pipeline project will include a high-pressure interstate natural gas pipeline system that is intended to extend from the Blanco Hub area in San Juan County, New Mexico, continuing south and west to various points located in the Phoenix area and then to points along the Arizona/California border near Ehrenberg, Arizona, and is planned to have capacity of 750,000 Dth per day or more, with access to gas located in the San Juan and Rocky Mountain producing basins; and

WHEREAS, the Silver Canyon Pipeline project is intended to include construction of various points of delivery and interconnection along the route of the pipeline system, including connections to third-party pipelines, storage projects planned in Arizona, and interconnects with Southern California Gas Company ("SoCalGas") and North Baja Pipeline at the Arizona/California border near Ehrenberg, Arizona; and

WHEREAS, Silver Canyon and TransColorado Gas Transmission Company ("TransColorado") have previously conducted binding Open Seasons for capacity subscription, related to the Silver Canyon Pipeline project and the TransColorado project, including a proposed extension of the TransColorado system described as the "Mainline Extension" from the Blanco Hub to the Window Rock area, each of which respective Open Seasons closed on April 30, 2003, and estimated maximum applicable transportation service rates ("Recourse Rates") were offered in those Open Seasons; and

WHEREAS, Silver Canyon is continuing its efforts to develop the new pipeline facilities and to proceed with obtaining all of the necessary governmental authorizations to construct the pipeline facilities, provided that Silver Canyon receives sufficient commitments for firm transportation service; and

WHEREAS, this Precedent Agreement with the attached Appendix A has been executed as evidence of the agreement between Silver Canyon and Shipper that, upon satisfaction of the conditions precedent set forth below and in the Appendix A attached hereto, the parties will enter into an Enhanced Firm Transportation Service Agreement providing for firm interstate natural gas transportation service to be provided by Silver Canyon for Shipper.

NOW, THEREFORE, in consideration of the mutual covenants and agreement contained herein, and intending to be legally bound, Silver Canyon and Shipper agree as follows:

1. Effective Date and Term

This Precedent Agreement shall become effective on the date of its execution by both parties and shall remain in effect until the earlier of: (a) the effective date of the Enhanced Firm Transportation Service Agreement, or (b) either Shipper's or Silver Canyon's exercise of its termination rights pursuant to this Precedent Agreement. The Parties agree to process this Precedent Agreement for execution in a timely manner.

2. Services

As conditioned herein, Silver Canyon agrees to cause construction of the pipeline facilities necessary and acquire any capacity necessary to provide firm transportation service to meet Shipper's needs as set forth on the attached Appendix A. The construction and operation of interstate facilities shall be subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC").

3. Rates

Shipper agrees to pay the Reservation Rate(s) as stated on Appendix A for the entire term of its Enhanced Firm Transportation Service Agreement as specified on Appendix A. The Commodity Rate, Fuel and Lost and Unaccounted for Gas ("FL&U"), ACA and any other additional authorized charges will be charged in accordance with Silver Canyon's then effective FERC Gas Tariff. Silver Canyon has proposed, subject to FERC approval, that FL&U shall be assessed in-kind and will be adjusted through a tracking provision to be included in its FERC Gas Tariff.

4. Volume, Term, Receipt and Delivery Points, Other Services or Service Attributes

The Maximum Daily Quantity ("MDQ") is as elected by Shipper on the attached Appendix A. The primary term specified on Appendix A and the payment of reservation charges will begin with the first November 1 occurring after 1) the project is placed in-service and 2) Silver Canyon has advised Shipper by the preceding July 1 that the project will be in-service that November 1. Shipper's elections of Primary Receipt and Delivery Points are set forth on Appendix A. Secondary Receipt and Delivery Points will be made available pursuant to conditions set forth in Silver Canyon's FERC Gas Tariff, as approved by the FERC.

5. **Conditions to Silver Canyon's Obligations**

Silver Canyon's obligations to provide firm transportation services and to cause the construction of the project are subject to the following conditions:

a. All requisite governmental approvals must be obtained and maintained on terms acceptable to Silver Canyon, including approval of the construction, rates, and terms and conditions of services to be provided; and

b. All rights-of-way and other surface rights required to site the pipeline along the route described herein must be obtained on terms and conditions acceptable to Silver Canyon; and

c. Sufficient firm capacity subscription must exist, in Silver Canyon's sole opinion, to proceed with the project, and sufficient capacity must exist to provide the service; and

d. The project must remain economically viable, in Silver Canyon's sole discretion; and

e. Shipper shall have and maintain such credit as is required by Silver Canyon, in its reasonable discretion, to satisfy Shipper's financial obligations under the Enhanced Firm Transportation Service Agreement which is the subject of this Precedent Agreement. Such credit assurances may consist of prepayment of value of up to 3 months of Shipper's reservation charges, resulting from the volumes and rates stated on Appendix A, or such other credit assurances as Silver Canyon may require. Such assurances shall be provided by Shipper within 15 days of written notice by Silver Canyon.

6. **Shipper's Obligations**

a. Subject to the provisions of Sections 4 above and 9 d below, Shipper agrees that it will execute an Enhanced Firm Transportation Service Agreement, within five (5) business days after receipt from Silver Canyon, in accordance with the terms of this Precedent Agreement and the Appendix A attached hereto; and

b. Upon request of Silver Canyon, Shipper agrees to support any notification, tariff filing, application or certificate filing made to the FERC, or any other government body to obtain any necessary authorizations to construct and operate facilities or to provide services as set out herein; and

c. Shipper must initially provide sufficient evidence of credit worthiness, as reasonably determined by Silver Canyon, along with the return of this signed Precedent Agreement. Shipper shall have and shall continue to maintain such credit and provide assurances, as are required by Silver Canyon in its reasonable discretion, to satisfy Shipper's financial obligations under the Enhanced Firm Transportation Service Agreement which may result from this Precedent Agreement. Such credit assurances may consist of prepayment of value of up to 3 months of Shipper's reservation charges, resulting from the volumes and rates stated on Appendix A, or such other credit assurances as Silver Canyon may require. Such assurances shall be provided by Shipper within 15 days of receipt of written notice from Silver Canyon.

7. **<u>Blanco to Window Rock Area Capacity</u>**

To the extent that Appendix A reflects a receipt point at the Blanco Hub, Silver Canyon, at its election and in its sole discretion, can provide capacity from the Blanco Hub to the Window Rock area via one of the following: 1) a Silver Canyon owned pipeline, 2) a joint venture with TransColorado, 3) Silver Canyon leasing capacity on a TransColorado-owned pipeline, or 4) Silver Canyon acquiring capacity on a TransColorado-owned pipeline, directly or by capacity release.

8. **<u>Timing</u>**

Silver Canyon anticipates having the pipeline facilities ready for service on or about July 1, 2006, conditioned upon receipt of all necessary regulatory and other approvals by August 1, 2005. However, if Silver Canyon is unable to commence the transportation service as contemplated hereunder by July 1, 2006, Silver Canyon will proceed with due diligence to commence the transportation service for Shipper at the earliest practicable date thereafter.

9. **<u>Termination Rights</u>**

a. [redacted]

b. [redacted]

[redacted]

c. Any such termination mentioned above shall be effected by delivery by the terminating party of written notice to the other party within twenty (20) business days after the relied upon occurrence. Notice of termination delivered later than twenty (20) business days after the relied upon occurrence shall not be effective.

d. [redacted]

10. Authorities

Performance hereunder shall be subject to all valid laws, orders, decisions, rules and regulations of duly constituted governmental authorities having jurisdiction or control of any matter related hereto. Should either of the parties, by force of any such law, order, decision, rule or regulation, at any time during the term of this Precedent Agreement be ordered or required to do any act inconsistent with the provisions hereof, then for the period during which the requirements of such law, order, decision, rule or regulation are applicable, this Precedent Agreement shall be deemed modified to conform with the requirements of such law, order, decision, rule or regulation; provided, however, nothing herein shall alter, modify or otherwise affect the respective rights of the parties to cancel or terminate this Precedent Agreement under the terms and conditions hereof.

11. Assignment

This Precedent Agreement, in whole or in part, may be assigned by Silver Canyon to a wholly or partially owned affiliate, special purpose joint venture, partnership, or other affiliated entity, including a parent company or partnership. Shipper may assign this Precedent Agreement and any of the rights or obligations and any associated Enhanced Firm Transportation Service Agreement to any wholly owned affiliate which satisfies the credit worthiness standards of Silver Canyon and which is a successor to the business for which the transportation service was initially secured. Once the pipeline is in-service, Shipper may release its capacity under the Enhanced Firm Transportation Service Agreement pursuant to the terms of Silver Canyon's then existing FERC Gas Tariff. In the case of any proposed permanent release of any capacity under the Enhanced Firm Transportation Service Agreement, prior approval of KMP's lenders may be required, which approval shall not be unreasonably withheld. In the case of any other proposed assignment of this Precedent Agreement, or subsequent Enhanced Firm Transportation Service Agreement, prior approval of Silver Canyon is required, which approval shall not be unreasonably withheld.

12. **Choice of Law**

AS TO ALL MATTERS OF CONSTRUCTION AND INTERPRETATION, THIS BINDING PRECEDENT AGREEMENT SHALL BE INTERPRETED, CONSTRUED AND GOVERNED BY THE LAWS OF THE STATE OF TEXAS, WITHOUT REGARD TO THE CHOICE OF LAW RULES OF THAT STATE.

13. **Confidentiality**

Due to competitive concerns of Silver Canyon and Shipper, each party and its respective agents, employees, affiliates, officers, directors, attorneys, auditors and other representatives shall keep and maintain this Agreement and the individual provisions hereof in strict confidence, and shall not transmit, reveal, disclose or otherwise communicate any of the provisions hereof to any person without first obtaining the express written consent of the other party, which consent shall not be unreasonably withheld. Notwithstanding this provision, each party understands and agrees that this Precedent Agreement may be filed with FERC and used in support of any certificate application filed by Silver Canyon related to the facilities envisioned herein.

14. **Further Assurance**

Silver Canyon and Shipper shall enter into such additional agreements as may be necessary in furtherance of this Precedent Agreement.

Accepted and Agreed as of the date first above written:

SILVER CANYON PIPELINE LLC

Name: Steven M. Harris

Title: President, Silver Canyon Pipeline LLC

SOUTHWEST GAS CORPORATION

Name: Thomas J. Armstrong

Title: Vice President/Gas Resources & Energy Services

APPENDIX A
To
PRECEDENT AGREEMENT
(Dated January 9, 2004)
Between
Silver Canyon Pipeline LLC (Silver Canyon)
And
Southwest Gas Corporation (Shipper)

Contents Redacted

Exhibit B

Contents Redacted