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NEW APPLICATION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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E-01345A-04-0273

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR DETERMINATION OF PRUDENCE AND APPROVAL OF RATEMAKING TREATMENT RELATING TO NATURAL GAS INFRASTRUCTURE	DOCKET NO. E-01345A-04-___ **APPLICATION**

Pursuant to the Arizona Corporation Commission's ("Commission") Policy Statement Regarding New Natural Gas Pipeline and Storage Costs ("Policy Statement"), issued December 18, 2003, Arizona Public Service Company ("APS" or "Company") hereby submits this Application seeking a determination of prudence and approval of the ratemaking treatment for costs incurred under the Enhanced Firm Transportation Service Agreement ("EFTS Agreement") between APS and Silver Canyon Pipeline, LLC ("Silver Canyon") for natural gas transportation. As to the latter, APS proposes to recover such costs through the power supply adjustment mechanism ("PSA") presently under consideration by the Commission in Docket No. E-01345A-03-0437 or alternatively, through a separate cost deferral mechanism as described herein.

I. INTRODUCTION AND REGULATORY BACKGROUND

On April 15, 2003, the Commission issued the Notice of Inquiry on the Issue of Arizona Corporation Commission Policy and Action on Natural Gas Infrastructure Matters in Arizona ("NOI"). The NOI recognized the monopoly of El Paso Natural Gas Company's ("EPNG") interstate pipeline system, as well as both the volatility of natural gas prices and the increased demand on the EPNG system. The Commission sought comments and suggestions on future natural gas infrastructure issues, especially natural gas storage facilities and additional interstate pipelines.

APS responded to the NOI on May 30, 2003. In its response, APS strongly supported the Commission's proactive support of Arizona electric utilities and local gas distribution companies ("LDCs") in participating in the development and construction of both pipelines and storage capacity. The Commission received other responses from electric utilities, LDCs and citizens' groups. All supported the Commission's efforts to encourage the development of a reliable energy infrastructure in Arizona.

After reviewing the numerous responses, the Commission scheduled workshops to provide an opportunity for additional discussions among the many interested parties. The Commission's Utilities Division Staff developed a "strawman" proposal to be used for discussion purposes at the workshops. After significant input and discussion from many interested parties, including APS, the Commission issued its Final Policy Statement on December 18, 2003. The Policy Statement, while recognizing the need for a reliable and secure natural gas infrastructure, also recognized that cost recovery was a "significant issue" that should be addressed by the Commission. The Policy Statement encouraged utilities to file applications such as this, including any requests for alternate cost treatment for consideration by the Commission.

To address its future needs for a secure and reliable gas supply and the means to deliver such supply, APS has reviewed various interstate pipeline and market area storage proposals. One project that APS has determined meets those needs is the Silver Canyon Pipeline to be built by Kinder Morgan Energy Partners ("KM"). In fact, Southwest Gas Corporation has also requested essentially the same Commission determinations as APS for this project in an application filed in Docket No. G-01551A-04-0192.

II. DESCRIPTION OF PROJECT AND RELATED CONTRACTS

The Silver Canyon project will include a high-pressure interstate natural gas pipeline system that will 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. The project is planned to have a capacity of 750,000 Dth per day or more, with access to gas located in the San Juan and Rocky Mountain producing basins.

The pipeline 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, such as SoCal Gas and North Baja Pipeline at the Arizona/California border, storage projects planned in Arizona, and one or more interconnections with EPNG.

On September 29, 2003, APS entered into a Precedent Agreement ("PA Agreement") with Silver Canyon. That agreement establishes the conditions and prerequisites for APS to ultimately acquire firm capacity rights on the proposed pipeline pursuant to the EFTS Agreement. A redacted copy of the PA Agreement is attached as Attachment A.[1]

Under the PA Agreement, Silver Canyon agrees to build a pipeline facility to provide a firm transportation service to meet APS' needs. An EFTS Agreement will be executed when the conditions in the PA Agreement are met. The principal terms of the EFTS Agreement are listed in Appendix A of the PA Agreement. Pursuant to the EFTS Agreement, upon operation of the pipeline, APS agrees to pay a fixed Reservation Rate. The Commodity Rate, Fuel and Lost and Unaccounted for Gas ("FL&U"), Annual Charge Adjustment and any other additional authorized charges will be charged pursuant to Silver Canyon's then effective FERC Gas tariff. Silver Canyon will seek FERC approval for assessing in-kind and adjusted FL&U through an annual tracking provision to be included

[1] An unredacted copy of the PA Agreement will be provided to Staff pursuant to a protective agreement.

in its FERC Gas Tariff. If FERC approval of an annual fuel tracking mechanism is not granted, then Silver Canyon and APS shall negotiate in good faith an alternate method for recovering FL&U.

APS will retain the ability to add future primary receipt and delivery points, at the applicable zone rate, not to exceed APS' total Maximum Daily Quantity ("MDQ"). Silver Canyon agrees to interconnect with EPNG's southern system and provide the ability to physically flow up to APS' MDQ into the EPNG system to facilitate a backhaul displacement of capacity to APS' power plants on EPNG's system.

III. GENERAL DISCUSSION

APS, like many electric utilities, has experienced a significant growth in the use of natural gas as a primary fuel for generation of electricity. The Company's electric load growth is expected to continue at a rate significantly above the national average. Consequently, the resource plans of APS anticipate a significant growth in the use of gas-fired generation, which can be met either through the running of its own units or through "tolling" arrangements with the gas-fired plants owned by others. Regardless of who owns the gas-fired generation, APS believes an important factor in its ability to manage the electricity costs to customers is to optimize the integration of the entire natural gas supply chain, including the transportation component.

The interstate natural gas transportation service to all of the APS gas-fired power plants currently is provided by EPNG's southern mainline. The majority of Arizona natural gas consumers and other east of California ("EOC") shippers are captive to EPNG because the EPNG system is the only available transportation option in this region. The service was historically a Full Requirements ("FR") service that allowed EOC customers flexibility in the amount of transportation service available (up to each customer's full requirements) and provided flexibility in the customer choice of supply basin.

Over the past several years, the continuation of the FR service has been the subject of a complaint before the FERC. The FERC has ordered conversion of the EPNG contracts with APS and other EOC shippers from FR contracts to Contract Demand ("CD") contracts. The conversion, effective September 2003, limits the amount of capacity available to APS to a specified limit (called the "Contract Demand"), limits flexibility of APS to obtain gas from lower cost supply basins, and allocates to APS some capacity that is not available to APS delivery points on a firm basis. The conversion to CD contracts has heightened both APS' desire and its need for diversification of transportation options. The Silver Canyon project represents an opportunity for APS to diversify the Company's interstate transportation portfolio to the benefit of APS customers and the other gas consumers in the State of Arizona, without significant near term cost increases, even under conservative assumptions.

Over the last three years, the number of gas-fired generating facilities interconnecting with the southern EPNG system has grown significantly. The construction of another pipeline will provide additional access to important (and lower cost) supply basins, improve the security of supply, and increase transportation capacity to Southwest Arizona.

The recent FERC imposed changes in the structure of APS' transportation contract with EPNG have limited the Company's ability to access lower cost supply basins. Silver Canyon pipeline provides direct access to the historically lower cost San Juan supply basin. It also provides the ability to easily access the Rocky Mountain supply basin through interconnecting pipelines. The Rocky Mountain basin will be important over the long term because it is the only natural gas production area of the United States that is projected to have the capacity for substantial future growth.

IV. BENEFITS

The diversity in supply and infrastructure created by completion of the Silver Canyon project offers the opportunity for future gas transport contract savings by establishing competition in transport suppliers. A competitive transportation market should allow APS and other natural gas shippers in Arizona to negotiate more favorable transportation agreements and force transportation suppliers to offer competitive services and flexibility to consumers.

Transportation and supply basin diversity will allow APS to mitigate the volatility of gas prices and market risk. This diversity will allow APS to adjust supply sources and fine tune commodity mix to reduce the delivered price volatility to APS of an inherently volatile natural gas markets. Silver Canyon will interconnect with the EPNG system in the Phoenix area. It is anticipated that the combination of the additional Silver Canyon supply and the interconnection point with EPNG will create a "market hub" for gas trading in the Phoenix area and increase market liquidity. Such increased local market liquidity will permit more efficient hedging strategies by the Company.

Projects being considered to develop natural gas storage in Arizona also would benefit from increased pipeline options and local market hub development. Storage is more valuable to users when the location has market liquidity and multiple transport options. The ability to trade gas or move gas to the California market can help APS manage the commodity risk and optimize the cost of gas and transportation for power generation.

Silver Canyon also offers a number of operational advantages to customers. The first is the provision of pressure guarantees at the points of delivery on their system. In addition, the service allows a degree of shaping of capacity, which will allow APS to more closely match the seasonal and daily variations in APS gas demand with the service.

V. COSTS

APS has performed comparative analyses of the cost impact of the project. APS compared the overall cost of natural gas supply for native load peak needs under two alternatives: 1) maintain the status quo with transportation under El Paso system only; or 2) transportation using a combination of El Paso and Silver Canyon. APS considered other alternatives, but they were not deemed to be viable options due to project time constraints or financial feasibility requirements, and therefore, were not part of the final economic impact analysis.

The analysis was prepared using very conservative estimates of both future wholesale electric prices and of the differential between San Juan basin gas and that secured from other basins.[2] The results indicate that, under the second alternative, diversification with Silver Canyon, there would be a relatively small increase in the total cost of gas supply due to an increase in cost for transportation to meet native load peak needs over the term of the contract. In the first full year of service, 2007, total annual cost of gas supply is over $323 million. This represents a 2.4 % increase in cost to APS or $7.8 million. By 2015, the total annual cost of supply is over $543 million and the additional costs attributed to the Silver Canyon project are projected to be down to 0.6 % or $3.2 million for the year. Additionally, any increase in costs for transportation would, in the Company's view, be offset by a number of positive impacts such as: (1) the likely decrease in commodity costs (due to greater access to the San Juan basin); (2) the existence of competing pipelines; (3) access to basins with larger reserves versus declining basins; (4) the possibility of greater than expected increases in EPNG costs; and (5) the reliability benefits of having alternate transportation options. If the analysis included less conservative assumptions as to the key factors, it may further offset the

[2] Because Silver Canyon provides greater access to the San Juan basin, the greater that price differential, the more valuable is Silver Canyon. Likewise, the higher purchased power costs are relative to gas, the more gas APS will burn in its own plants or in tolled plants, and the more through-put on Silver Canyon, the lower its per MCF cost.

increase in transportation costs, and potentially make the economics of the Silver Canyon project positive.

In general, the fixed capacity charges for service under a newly constructed pipeline are slightly more expensive than an existing pipeline, and Silver Canyon is no exception. There are, however, anticipated commodity and variable cost savings with Silver Canyon that partially offset the increased fixed components. The magnitude of that offset is dependent upon both the basin differential previously discussed and the level of gas throughput, which once again are based on conservative assumptions as to each. Any net difference should be viewed as an "insurance" premium to be paid for reliability, flexibility, and competitive options. APS believes this potential, albeit small, premium would be a prudent investment in Arizona's infrastructure to meet the growing demand of its citizens for reliable and affordable natural gas.

Furthermore, the investment of time and money must be made now to meet the needs of the future. The Silver Canyon project routing currently contemplated runs to the Palo Verde area through an area west of the White Tanks and is believed to have minimal impact on communities. Development in the West Valley is proceeding at a very high rate and key infrastructure projects such as this will only become more difficult if undertaken after significant residential and commercial development are in place.

APS anticipates that even if everything progresses well, under an optimistic time line with no regulatory or other delays, the additional infrastructure will not be available for use until at least the third quarter of 2006. The contractual flexibility to step down on committed capacity levels on EPNG is an important aspect of the cost analysis and timing of this project. APS must be assured that the Silver Canyon project is viable and that FERC permitting is completed by December 2005 before APS would be willing to provide step-down notifications to EPNG. Sufficient firm capacity subscription, however, must exist for the Silver Canyon project to proceed and provide the service. The timing of this project will require prompt action by not only this Commission, but also FERC and the Silver Canyon project developers.

VI. KEY MILESTONE DATES

APS respectfully requests a final decision from the Commission within 90 days of this filing to allow the project to proceed expeditiously on the timeline set by Silver Canyon to meet the proposed completion date of July 2006. Silver Canyon has put forth the following project timeline:

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

VII. PROPOSED PRUDENCE FINDING AND RATE RECOVERY MECHANISM

APS requests that the Commission allow the Company to recover its costs incurred under the EFTS Agreement through the comprehensive PSA proposed in its current rate proceeding, Docket No. E-01345A-03-0437. Alternatively, if the Commission does not approve such a PSA in the current rate case, APS requests Commission authorization to defer the costs associated with the EFTS Agreement as a regulatory asset for future recovery in a subsequent base rate case.

In either event, the Company asks that the Commission find that it is prudent for APS to enter into the EFTS Agreement and that the costs incurred under the EFTS Agreement will be considered as prudently-incurred and subject to full cost recovery.

VI. CONCLUSION

The EFTS Agreement and alternate cost recovery proposed by APS respond to the Commission's concerns regarding natural gas infrastructure in Arizona as raised in the Commission's Policy Statement and are in the public interest. Accordingly, APS requests that the Commission find the EFTS Agreement to be reasonable and prudent and in support of the Commission's Policy Statement. APS also requests that the Commission approve recovery of costs incurred by APS under the EFTS Agreement through the PSA or, in the alternative, through a deferral of such costs for future recovery in a subsequent rate case.

RESPECTFULLY SUBMITTED this 9th day of April, 2004.

PINNACLE WEST CAPITAL CORP.

Thomas L. Mumaw
Karilee S. Ramaley

SNELL & WILMER L.L.P

Jeffrey B. Guldner
Kimberly A. Grouse

Attorneys for Arizona Public Service Company

Attachment A

KINDER MORGAN

March 30, 2004

Mr. Marc Sauvageau
Arizona Public Service Company
Director, Fuel Procurement
400 N. 5th Street, M.S. 8974
Phoenix, AZ 85004

RE: Precedent Agreement Between Arizona Public Service Company and Silver Canyon Pipeline LLC dated September 29, 2003, as amended.

Dear Marc:

Arizona Public Service Company ("APS") and Silver Canyon Pipeline LLC ("Silver Canyon") are parties to that certain Precedent Agreement dated September 29, 2003, as amended November 24, 2003 and February 9, 2004 (the "Agreement"). APS and Silver Canyon hereby acknowledge that the February 9, 2004 amendment (which was in the form of a fully executed form of the Agreement which reflected certain changes) erroneously had the Agreement dated August 29, 2003. APS and Silver Canyon now desire to further amend the Agreement as follows:

Section 9 (a)(6) is deleted in its entirety and replaced with the following:

> "Silver Canyon has not issued a public notice that it will proceed with the Silver Canyon Pipeline project prior to June 30, 2004."

If APS is in agreement with the above, please execute this Letter Agreement which will become effective upon its execution on behalf of APS by a duly authorized representative and its return to Silver Canyon. If you have any questions, please contact me at 713-369-9214. Thank you.

Sincerely,

Steven M. Harris
President, Silver Canyon Pipeline LLC

Arizona Public Service Company

By: Marc Sauvageau

Title: Director - Fuel Procurement

PRECEDENT AGREEMENT
Between
Silver Canyon Pipeline LLC
And
Arizona Public Service Company

This Precedent Agreement including the terms and conditions stated in Appendix A dated this 29th day of August, 2003 is between Silver Canyon Pipeline LLC ("Silver Canyon"), a Delaware limited liability company controlled by Kinder Morgan Energy Partners, L.P. ("KMP"), and Arizona Public Service Company ("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 are met in accordance herewith. The commitment provided by Shipper via this Precedent Agreement will be used by Silver Canyon as support for the construction and operation of pipeline facilities designed to meet Shipper's requirements for firm natural gas transportation service. And the commitments provided by Silver Canyon will be used as support for the satisfaction of Shipper's contractual obligations to serve. 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 may 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 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 SoCal Gas and North Baja Pipeline at the Arizona/California border near Ehrenberg; and,

WHEREAS: Silver Canyon and TransColorado Gas Transmission Company 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 in efforts to develop the above-described new pipeline facilities and to proceed with obtaining all of the necessary governmental authorizations to construct its pipeline facilities, provided that Silver Canyon receives sufficient commitments for firm transportation service; and,

WHEREAS: This Precedent Agreement has been executed as evidence of the agreement between Silver Canyon and Shipper that, upon satisfaction of the conditions precedent set forth below, 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 terminate upon 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 payment of reservation charges will begin to accrue when the project is placed in-service. In-Service is defined as commercially operational.

Silver Canyon agrees that during the initial term of the Enhanced Firm Transportation Service Agreement Shipper shall have a minimum of two renegotiation opportunities to request Silver Canyon to consider changes to its tariff that are non-rate or contract termination related items. Such changes shall be considered in good faith by Silver Canyon and can not be unreasonably withheld by Silver Canyon.

2. **Construction and Services**

As conditioned herein, Silver Canyon agrees to cause construction of the pipeline facilities necessary and acquire any capacity necessary to provide a firm transportation service to meet Shipper's needs as set forth in Appendix A. [redacted] The construction and operation of all 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"), Annual Charge Adjustment ("ACA") and any other additional authorized charges will be charged in accordance with Silver Canyon's then effective FERC Gas Tariff. Silver Canyon is not precluded from seeking to recover additional FERC authorized charges in accordance with its then effective FERC Gas Tariff. Silver Canyon will propose, subject to FERC approval, that FL&U be assessed in-kind and adjusted through an annual tracking provision to be included in its FERC Gas Tariff. In the event FERC does not grant approval of FL&U being assessed through an annual tracking provision, Silver Canyon and Shipper shall agree upon an alternate mechanism for recovering the FL&U.

[redacted]

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

Shipper's Maximum Daily Quantity and initial term are as elected by Shipper on the attached Appendix A. Shipper's ratable hourly delivery rights are as described in Rate Schedule EFTS and shall not be more than one-sixteenth of shipper's daily nomination. The term specified on Appendix A and the payment of reservation charges will begin with the actual date the project is placed in-service. 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 which shall include the implementation of FERC Order No. 637 initiatives. Shipper shall retain the ability throughout the initial term of the EFTSA to add future primary Receipt and Delivery points (and pay the applicable zone rate) not to exceed Shippers' total MDQ.

Silver Canyon agrees to interconnect with El Paso Natural Gas Company's southern system and provide the ability to physically flow up to Shippers' MDQ into the El Paso system to facilitate a backhaul displacement of capacity to Shipper's power plants on the El Paso system.

Silver Canyon anticipates and is working towards attaching various receipts into Silver Canyon in the Blanco Hub area which include, but may not be limited to: Chaco Plant, Blanco Plant, Milagro Plant, Val Verde Plant (pending pressure issues being resolved) and TransColorado Gas Transmission Company.

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

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

a. All requisite governmental approvals must be filed for, obtained and maintained on terms reasonably acceptable to Silver Canyon, including approval of the construction, rates and terms and conditions of services, which shall not be inconsistent with this Agreement; 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 reasonably 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. If Silver Canyon determines, in its sole discretion, the project is not economically viable to proceed; Silver Canyon agrees that such determination will be made no later than thirty (30) days following Silver Canyon's receipt of the issuance of a Final Certificate Order by FERC; 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. A Shipper shall be deemed creditworthy if (i) its long-term unsecured debt securities are rated at least BBB- by Standard & Poor's Corporation ("S&P") or Baa3 by Moody's Investor Service (Moody's) and (ii) the sum of reservation fees for the contract term is less than 15% of the Shipper's tangible net worth. In the event Shipper is rated by both S&P and Moody's, the lower rating applies. If a Shipper has multiple agreements with Silver Canyon, the total of all such service agreements shall be considered in determining creditworthiness. In the event Shipper is not deemed creditworthy, Silver Canyon may require credit assurances. Shipper shall provide any such credit assurances required by Silver Canyon within 15 days of written notice by Silver Canyon. Such credit assurances shall be limited to a Letter of Credit, or the cash equivalent, in an amount equal to three (3) months of the reservation charges agreed to by Shipper under this Precedent Agreement. The obligation to maintain such credit assurance shall extend until such time as Shipper is deemed creditworthy as defined herein. Such credit assurances shall be held in a third party custodial account (which Silver Canyon will maintain control of) mutually acceptable to both Silver Canyon and Shipper. Shipper agrees it will be responsible for all costs associated with setting up and maintaining such account. The aforementioned obligations shall cease upon the FERC approved in-service date at which time the Silver Canyon tariff provisions shall govern.

f. Silver Canyon agrees that it will seek a FERC Gas Tariff which will provide for 1) the non-discriminatory use of flow control devices on its system, 2) segmentation rights, 3) non-ratable takes as defined in Rate Schedule EFTS for one-sixteenth of nominated hourly flow and 4) overrun penalties.

6. Shipper's Obligations

a. Absent mutual agreement to the contrary, Shipper agrees that it will execute an Enhanced Firm Transportation Service Agreement, within fifteen (15) business days after tendering of such agreement to Shipper by Silver Canyon, provided the Enhanced Firm Transportation Service Agreement tendered by Silver Canyon is in accordance with the terms of this Precedent Agreement and Appendix A; 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 consistent with the terms herein; and,

c. In addition to the obligations of Paragraph 5(e) above, Shipper must initially provide sufficient evidence of credit worthiness, as reasonably determined by Silver Canyon, along with the return of this signed Precedent Agreement.

7. Blanco to Window Rock Area Capacity

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. Timing

Silver Canyon will proceed with due diligence to have 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. **Termination Rights**

a. [redacted]

b. No contract termination exit fee shall be assessed to Shipper.

c. Silver Canyon may terminate this Precedent Agreement prior to the effective date of the Enhanced Firm Transportation Service Agreement if: (1) FERC shall deny the certificate application to construct the facilities; or (2) FERC shall require modifications to, or attach conditions to, any applicable rate, tariff provision, or certificate which results from the certificate application which, in Silver Canyon's sole judgment, are unacceptable; or, (3) [redacted] or, (4) Silver Canyon determines, in its sole discretion, the project is not economically viable to proceed; with such determination to be made no later than thirty days following Silver Canyon's receipt of the issuance of a Final Certificate Order by FERC; or, (5) Shipper fails to maintain creditworthiness as defined in Silver Canyon's FERC approved tariff.

d. Any termination of this Precedent Agreement by either Silver Canyon or Shipper 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.

e. [redacted]

10. Authorities

Performance hereunder shall be subject to all applicable 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 requirement 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, provided such assignment is to an entity of same or greater credit rating and such assignment does not alter the Shipper's rights or entitlements. Shipper may assign this Precedent Agreement and any of the rights or obligations and any associated Firm Transportation Service Agreement to any wholly or partially owned affiliate, special purpose joint venture, partnership, or other affiliated entity, including a parent company or partnership, provided such assignee 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 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 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 Firm Transportation Service Agreement, prior approval of the other party 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 COLORADO, 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; provided, however, that if either party is requested or ordered by any court, agency or other authority to disclose such information, that party will give the other party prompt written notice of such request or order so that an appropriate protective order may be sought. To the extent permitted by law, each party agrees not to oppose the other's efforts to prevent the disclosure of such information. 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. <u>Further Assurance</u>

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 hereof:

SILVER CANYON PIPELINE LLC

Name: Steven M. Harris

Title: President, Silver Canyon Pipeline LLC

ARIZONA PUBLIC SERVICE COMPANY

Name: Marc T. Lauzeau

Title: Director - Fuel Procurement

APPENDIX A
To The
PRECEDENT AGREEMENT
Between
Silver Canyon Pipeline LLC ("Silver Canyon")
And
Arizona Public Service Company ("Shipper")

Shipper makes the following elections for service from the Silver Canyon Pipeline Project:

	Primary Receipt Point	Primary Delivery Point	MDQ (Dth/d)	Rate
1.	Blanco Hub Area Supply Pool	EPNG South Mainline Interconnect	*see table below	[redacted]
		TOTAL MDQ	*	

The fixed Negotiated Rate is for transport from the Blanco Hub area to Shipper's Primary Delivery Point.

*MDQ:

Month	Volume (Dth/d)
January	[redacted]
February	
March	
April	
May	
June	
July	
August	
September	
October	
November	
December	
Monthly Daily Average	

Length of Term: Ten (10) years beginning on the later of July 1, 2006 or the in-service date of the pipeline facilities stated herein.

EFTSA Rate: Negotiated Rate of $0.[redacted]/Dth/d

Authorized Overrun Rate during the initial term of the agreement shall be the lesser of $0.[redacted]/Dth/d or the FERC approved Authorized Overrun Rate as stated in Silver Canyon's FERC Gas Tariff.

Silver Canyon agrees to allow Shipper the Right of First Refusal under the EFTSA.