

**ARIZONA PUBLIC SERVICE COMPANY'S
RESPONSE TO NOTICE OF INQUIRY ON THE ISSUE OF
ARIZONA CORPORATION COMMISSION
POLICY AND ACTION ON
NATURAL GAS INFRASTRUCTURE MATTERS
IN ARIZONA**

Submitted to the Arizona Corporation Commission
Utilities Division Staff

May 30, 2003

I. INTRODUCTION

Arizona Public Service Company (“APS” or “Company”) hereby responds to the Notice of Inquiry (“Notice”) issued by the Utilities Division Staff (“Staff”) of the Arizona Corporation Commission (“Commission”) on April 15, 2003 regarding the “Policy and Action on Natural Gas Infrastructure Matters in Arizona.” As Staff noted in its introduction to the Notice, several relatively recent developments have significantly increased the importance of natural gas infrastructure matters both to the Company and to Arizona as a whole. Those issues will not only continue to be important, but are likely to increase in importance over the next few years as the pending El Paso Natural Gas (“El Paso”) proceedings before the Federal Energy Regulatory Commission (“FERC”) are resolved and potential El Paso competitors evaluate the feasibility of constructing new pipelines and/or storage projects to serve Arizona.

APS has welcomed the Commission’s involvement in the pending FERC proceedings and in seeking to protect gas transportation for Arizona generating facilities and local distribution companies (“LDCs”). The Commission has been very instrumental in advancing the concerns of the Full Requirements shippers before the FERC and APS urges the Commission to continue its necessary participation in the FERC proceedings. APS also supports Staff’s furtherance of a dialogue on the impact of the natural gas infrastructure on electric utilities and LDCs and, ultimately, their customers.

APS supports the Commission’s consideration and implementation of means and options that will encourage the development and construction of both pipelines and gas storage facilities to serve Arizona utilities and LDCs. The addition of new pipelines and storage capacity will increase reliability and deliverability and reduce the State’s dependence on the sole existing pipeline serving the bulk of Arizona users, which ultimately should result in lower costs for Arizona customers. To further such result, it is important to avoid duplicative or conflicting regulation that easily could negate the benefits of having additional pipelines or gas storage facilities. Instead, the coordination of any policies implemented by the Commission with the FERC’s siting and operational requirements would enhance efficiency of regulation and reduce regulatory costs.

Section II of this Response addresses the specific questions posed by Staff in the Notice.

II. QUESTIONS AND RESPONSES

1. **Should the Commission develop formal or informal policies regarding the use of natural gas storage by Arizona utilities?**

Under the Natural Gas Act, the FERC has jurisdiction over “the transportation of natural gas in interstate commerce.” 15 U.S.C. § 717c(a). Because storage of natural gas originating out of state and delivered by pipelines to storage facilities in Arizona is within the definition of “transportation” (*see* 18 C.F.R. § 284.1(a)), FERC is primarily responsible for the siting, certification, development and regulation of such facilities. Other storage facilities attached to local distribution systems or operated as “private use” facilities could be exempt from FERC jurisdiction. While APS, as explained above, encourages the Commission, to the extent that it can, to foster an environment that will lead to the development of natural gas storage facilities in Arizona, APS also cautions the Commission to avoid, where reasonably possible, duplicative or conflicting regulation over such facilities. Arizona has natural resources that are conducive to the construction of gas storage facilities. Facilitating the certification process for those resources would expedite the development of natural gas facilities within the state, reduce reliance on a single pipeline (El Paso), enhance competition and make Arizona less vulnerable to such external factors as mainline pipeline constraints, pro-rationing, and long-haul deliverability concerns, among others.

Gas storage also increases the options available to LDCs and electric utilities to optimize fixed transport and storage costs in such a manner that total costs to consumers may be reduced. Unfortunately, developers are hesitant to invest the significant capital required to site and develop such facilities without prior assurance of long-term storage contracts with LDCs and electric utilities sufficient to justify the economics of facility development. At the same time, however, LDCs and electric utilities are equally hesitant to enter into such long-term contracts without some assurance that they will be able to recover the costs of such contracts. A Commission policy ensuring that LDCs and electric utilities would receive prompt review of the prudence of such contracts and consequent assurance of full cost recovery would address many of those concerns and encourage development of gas storage facilities in Arizona.

2. **Should natural gas storage use by electric utilities be viewed and treated differently than natural gas storage used by natural gas local distribution companies? Please explain.**

Historically, natural gas was predominantly used to serve heat load customers and only to a secondary and lesser extent for electric generation loads. Over the past several years, however, uses of natural gas have changed dramatically. In fact, the Energy Policy Act of 1992, 16 U.S.C. §2621(1992) and 42 U.S.C. §13451(1992), actively encouraged the use of natural gas by electric utilities and in recent years electric utility reliance on natural gas generation has increased significantly. A key value of natural gas storage is that it reduces a user’s overall need for pipeline capacity by acting as a surge tank on the system—a factor of equal value to both electric utilities and LDCs.

APS believes that neither electric utilities nor LDCs should have priority over natural gas or its related facilities. Today, both electric utilities and LDCs rely on natural gas to serve a high priority, human needs customer base. Indeed, as the Commission knows, the El Paso system in Arizona has now become a dual-peaking system, with a winter peak for LDCs (heating) and a summer peak for electric generation (cooling). And for most Arizona residents, temperature extremes are greater during the summer cooling season compared to the milder heating season—precisely the opposite of many other regions of the country.

3. What issues should the Commission address in creating any Commission policy on natural gas storage?

To encourage the construction of natural gas storage, perhaps the most significant issue the Commission should consider in establishing any policy on natural gas storage is cost recovery. Two types of cost recovery are at issue: (i) costs related to facilities that are not otherwise covered by the FERC policies (*i.e.*, involving intrastate commerce); and (ii) flow through of FERC-approved costs that are charged by pipelines to Arizona electric utilities or LDCs. The more confident a LDC or electric utility is that it will receive prompt review and recovery of costs incurred, the more likely it is to invest in the development of such infrastructure and ultimately enter into long-term contracts for natural gas storage (and pipeline capacity).

4. If Arizona utilities utilize natural gas storage, how should the Commission address the recovery of costs for such storage and what costs should be considered?

As mentioned above, APS believes that costs incurred for natural gas storage should be treated for purposes of cost recovery in the same manner as gas transportation costs. Both are critical to ensure the security and reliability of Arizona's gas supply. For example, gas storage costs should be recovered through a fuel or purchased gas adjustment clause in the same manner as transportation costs. Costs to be included in such recovery mechanism would be those costs described above in the response to Question 3. The failure to provide mechanisms that provide comparable opportunities to recover the costs of the various service options could create incentives to prefer one option over another.

5. Should the Commission encourage the use of natural gas storage for addressing natural gas price volatility, reliability of natural gas supply and/or other possible goals of natural gas storage? Please indicate which goals should be pursued as well as the relative importance of each goal.

APS supports the Commission's efforts to encourage use of natural gas storage to promote the goals of: (i) obtaining reliable service; (ii) mitigating price volatility; (iii) increasing competition; and (iv) promoting environmental/clean air initiatives. Bringing gas storage to Arizona not only will increase the reliability of the gas supply, but it will

also mitigate severe price volatility, provide for no-notice gas supply, and reduce the reliance of Arizona utilities and LDCs on costly interstate pipelines.

Having a reliable source of energy for Arizona should be a primary goal of the Commission because natural gas is crucial both to the economy and to human needs customers. In the past, the winter/summer price differentials determined the value/volatility of storage. Prices over the last few years, however, have not tracked the historical seasonal price differentials, thereby increasing the volatility and risk associated with storage. To encourage investment and development of storage facilities, the Commission should consider pre-approval process options that allow utilities and LDCs to make prudent investments into the research and development of and contracting for storage facilities. As the Commission is aware, competition can serve to reduce Arizona's dependency on the El Paso pipeline, which currently is the sole source for most of Arizona. In fact, the construction of storage may serve to break down barriers to entry by encouraging other pipelines to construct pipeline facilities into the state.

6. How should the Commission address the goal of maximizing customer benefits from natural gas storage while minimizing the cost to consumers of utilizing such storage?

The Commission can maximize customer benefits from natural gas storage and minimize the cost to consumers of utilizing such storage by allowing economical financing of such projects through greater assurance of full cost recovery by participating LDCs and electric utilities. Moreover, by taking an active role in the FERC certification process, the Commission also could assist in moving the project forward, which would provide competition to benefit the consumer as soon as possible. Having storage in Arizona provides its consumers with a locational advantage that is not presently available, thereby leading to increased reliability and deliverability of supply. In addition, storage allows entities to maximize the benefits of marketing storage to other states when not needed in Arizona.

7. How does the use of natural gas storage relate to other methods of reducing price volatility, such as the use of longer term supply contracts and financial hedging?

Storage provides one more tool, like long term supply contracts and financial hedging, to reduce price volatility. The added benefit of storage in Arizona is the locational advantage it provides. Having storage in Arizona, close to the delivery market, both reduces the risks associated with deliverability being subject to basin takeaway restrictions, mainline constraints or pro-rationing, and provides opportunities to use seasonal price variations to decrease total cost of supply because stored volumes act as a physical price hedge against changes in the market value.

8. Is there a relationship between the use of natural gas storage and what interstate pipeline capacity rights a utility holds? And if so, how should the Commission address this relationship?

The answer to the first question is “not necessarily.” However, if gas storage were available, utilities generally would seek to meet their projected needs with an optimum combination of storage and pipeline capacity. That optimum combination will vary by the utility, its load shape and whether the storage is available in the load center (and therefore acts like pipeline capacity and a production basin) or remotely only (and therefore acts only as a production resource that requires pipeline capacity for delivery of the gas).

As to the second question, APS must note that under FERC Order 637, a capacity holder is free to “segment” and utilize its interstate pipeline capacity in the manner it sees fit. As a result, the location of a storage facility has a direct impact on the use of existing transportation capacity or the need for additional transportation capacity. Because the FERC regulations already address this issue, there does not appear to be any need for additional Commission action at this time. Rather, APS believes that a goal of the Commission should be to ensure that the El Paso pipeline is obligated to implement the FERC’s Order 637 initiatives as soon as possible.

9. What monitoring, reporting, and evaluation should the Commission undertake in regard to Arizona utilities’ use of natural gas storage?

APS believes that the Commission should simply utilize the same monitoring, reporting and evaluation policies that it currently employs for the use by utilities and LDCs’ of pipeline capacity. Pipelines and storage facilities are in certain situations interchangeable resources. Consistency of monitoring and reporting requirements simplifies implementation of any such requirements, thereby reducing the costs of compliance and enhancing the ease of comparing these two options.

10. Should the Commission develop formal or informal policies regarding the use of interstate pipelines by Arizona utilities? If so, what areas should policies address?

APS encourages the Commission to consider policies that facilitate the development of interstate (and intrastate) pipelines while again avoiding, to the extent possible, the imposition of potentially conflicting or counterproductive regulatory requirements. Ideally, the Commission would view and treat the development of gas storage and interstate pipelines in a consistent manner. Any policy that reduces Arizona’s reliance on a single pipeline enhances competition and makes Arizona less vulnerable to external factors (*i.e.*, mainline pipeline constraints, pro-rationing and long-haul deliverability issues) should be viewed as constructive. *See* Response to Question 1. In addition, because the Commission’s involvement and support in the pending FERC proceedings relating to El Paso has been critical to addressing Arizona’s needs, APS urges the Commission to continue its active participation in those proceedings.

11. Are there ways the Commission could encourage use of interstate pipelines in ways that would enhance the reliability and reduce the costs of natural gas service in Arizona?

Bringing additional pipelines (and gas storage facilities) into Arizona clearly will enhance reliability and ultimately reduce costs as utilities and LDCs are able to access lower cost sources. Moreover, a pipeline that is fully subscribed ultimately will be less costly to the shipper than one that is not because more users share in the costs of the construction and operation of the pipeline. One means of encouraging utilities and LDCs to subscribe for capacity on new pipelines is to ensure prompt review and subsequent assurance of full cost recovery of prudently incurred costs associated with such subscriptions. *See* Response to Questions 3 and 4. In addition, because the FERC relies on state public utility commissions with respect to local needs issues, the Commission's active involvement in support of FERC certificate filings also would benefit consumers in Arizona.

12. How should the Commission balance goals such as reliability, cost, portfolio diversity, and operational flexibility as it considers the use of interstate pipeline facilities by Arizona utilities?

Generally, the market will dictate when additional pipeline facilities are necessary if competition is not thwarted by improper market behavior or regulatory inaction. Once the market indicates that new facilities are required (storage or pipeline), the Commission should facilitate increased reliability by providing a cost recovery mechanism that supports prudent investment. In the end, operational flexibility and portfolio diversity will be the result of the competition.

13. Previously the Commission has recognized the benefit of having Arizona local distribution companies have a diversified gas supply portfolio. Should the Commission encourage Arizona utilities to diversify their sources of interstate pipeline capacity, rather than relying on a single interstate pipeline for all pipeline capacity?

Yes, APS believes that the Commission should support the development of diverse sources of supply for Arizona, as such diversification provides the state's utilities with options for accessing expanding supplies and potentially lower commodity costs. Because of the magnitude of the investment required, however, utilities will not be able to pay for such diversification unless the Commission considers implementing a pre-approval process for such costs.

14. Are there other areas where the concept of a diversified supply portfolio can and should be applied by the Commission?

Because gas storage and pipeline construction both require significant capital expenditures unlike other potential areas such as financial hedging and contract portfolio management, and are therefore most in need of consistent supporting regulatory policies, APS encourages the Commission to focus its efforts on those activities.

15. Should the Commission address proposals for new pipelines, expansions of existing pipelines, or new storage facilities? If so, how should the proposals be addressed by the Commission?

Because the jurisdiction over such facilities lies with the FERC, the FERC ultimately will determine which pipelines or gas storage facilities are approved. However, the Commission could: 1) be an active participant in FERC certification proceedings by supporting the requisite demonstration of need, which is heavily relied upon by the FERC; 2) encourage the state to establish a “one-stop shopping” process for the requisite local and state approvals; and 3) institute an appropriate pre-approval/cost recovery mechanism to encourage investment in such ventures.

16. Are there other natural gas infrastructure issues which the Commission should be addressing?

Yes, the Commission should recognize the responsibility of utilities as the providers of last resort to human needs customers and be prepared to address “ownership” issues. As the Commission notes, El Paso is the only pipeline serving most of Arizona, which means that any diversification of ownership is better than that which currently exists. As discussed previously, pursuant to the Natural Gas Act, the FERC has implemented regulations that govern the activities of gas market participants and prohibitions against the use of market power. However, the Commission should consider means by which the Commission could facilitate the construction of facilities that would reduce the dependency of Arizona’s regulated utilities on the El Paso pipeline.

17. Should the Commission hold one or more workshops to further investigate natural gas storage and interstate pipeline issues?

Because regional planning and coordination on the issues raised by Staff in the Notice will benefit Arizona, APS supports the Commission’s holding of one or more workshops to discuss the issues raised.