

ARIZONA PUBLIC SERVICE COMPANY'S
COMMENTS ON THE STAFF STRAWMAN PROPOSAL
FOR NOTICE OF INQUIRY ON
NATURAL GAS INFRASTRUCTURE

September 25, 2003

I. Introduction and Summary

Arizona Public Service Company (“APS”) appreciates the interest and leadership that the Arizona Corporation Commission (“ACC” or “Commission”) has shown with respect to the need for ensuring adequate natural gas infrastructure in Arizona. APS urges the Commission to continue its proactive approach to addressing the issues arising from that goal before the need for additional infrastructure becomes critical. The Notice of Inquiry and workshop process have been and will be a constructive means for the Commission to support the development of such infrastructure.

APS believes that the key means by which the Commission can encourage infrastructure development will be to develop and implement a pre-approval process for regulated utilities. Such a process would include not only the pre-approval of anticipated development and construction costs for those regulated entities seeking to construct additional infrastructure, but also the pre-approval of long-term contracts that developers require from regulated utilities before investing significant amounts in development and construction. In addition, the Commission could encourage other state agencies to complete any approval process they are required to complete in a timely manner to avoid unnecessary delay of construction of such infrastructure.

Based on Arizona’s historical and projected population growth, APS will require additional pipeline and/or storage capacity by 2007 to meet its growing customer demand. As APS has indicated previously, the Company has for some time been evaluating both storage and pipeline project opportunities to address the Company’s need to meet that demand. In order for such projects to be completed in time to meet that demand, construction will need to commence soon, as development and construction often take three years or more to complete. Thus, it will be important for the Commission to implement an approval process quickly so development of the needed infrastructure is not further delayed. As the Commission heard at the September 10, 2003 Natural Gas Infrastructure Workshop, companies must make commitments several years in advance in order to have infrastructure in place when it is needed. Because APS anticipates needing access to additional pipeline and/or storage capacity by early 2007, APS needs to be able to make commitments soon. APS is prepared to work with the Commission and other interested parties to develop such a process and, in these comments, will offer some initial suggestions for Commission consideration.

II. Specific Comments on the Strawman Proposal

A. Supply/Infrastructure Diversity

APS generally agrees with the Commission Staff's Strawman discussion regarding the benefits of supply and infrastructure diversity. As Commission Staff has recognized, diversity is a fundamental element of risk management, and the problems created by a lack of diversity have become more evident in recent years due to the pending disputes relating to the El Paso Natural Gas ("El Paso") pipeline. Although the extremely beneficial service and cost elements inherent in El Paso's Full Requirements contract historically may have discouraged competitive pipelines from entering the market, the steady population growth in Arizona and the increased reliance on natural gas have resulted in changed circumstances that are now causing Arizona's dependence on a single pipeline to put its natural gas supply at risk.

Like Commission Staff, APS believes that diversification is needed on several levels and that the following should be considered when evaluating the available options:

- i) New pipeline(s) versus existing pipeline(s) – New pipelines generally bring with them decreased maintenance costs, increased safety and the capability of achieving higher operating pressures. On the other hand, older pipelines may be less expensive because some of the costs already have been recovered.
- ii) Diverse infrastructure options - The availability of more than one natural gas pipeline, as well as the addition of LNG terminals or storage facilities, offers increased reliability and security of supply, and allows the end user to optimize its system.
- iii) Diverse transportation suppliers – Generally, having more than one transportation supplier would be expected to lead to enhanced long-term competition for pipeline services, thereby leading to reduced rates over time.
- iv) Diverse supply basin options – The allocation recently implemented by the Federal Energy Regulatory Commission ("FERC") has limited the ability of Arizona shippers to access the lower-cost supply basins for incremental supply needs. Certain of the new pipelines currently being evaluated for development would give Arizona shippers access to the growing, and often less expensive, San Juan and Colorado Rockies supply basins.

B. Supply/Infrastructure Planning

APS agrees with Commission Staff that long-term planning is critical for developers of infrastructure and natural gas users in Arizona and that utilities (both electric and gas) should continue to plan for “natural gas infrastructure needs on a long term basis, recognizing that some decisions may not necessarily lead to the lowest cost in the short term.” Staff Strawman Proposal at 3. APS appreciates Commission Staff’s support for the ongoing efforts of the utilities to plan for their natural gas needs over the long haul and not just for today or tomorrow.

In light of the above, APS supports in general the concept of a statewide review and analysis of the State’s natural gas infrastructure needs and will participate in any process that the Commission establishes to complete such an analysis. It is important to recognize, however, that diverse interests and needs, as well as applicable antitrust laws, may limit the possibility of a common project. For example, individual utility circumstances (*i.e.*, location, capacity needs, timing and other issues) could make uniting behind a single project difficult. While certain Arizona shippers may decide to take the majority of flow off of the El Paso system due to the cost of constructing new lateral lines to serve their demands, other shippers may be located close enough to a new pipeline or storage project that the cost of constructing a lateral line makes the new pipeline or storage project worth pursuing.

Moreover, it will be important that any such effort not delay or impede the ability of Arizona utilities to make timely commitments that are needed to ensure reliability and stable costs in the future. For example, in order to meet the needs of APS’ own customers, APS may not be able to wait for the completion of a statewide analysis before moving forward independently with commitments or projects that will provide increased reliability and access to supply for its own customers.

C. Commission Approach to New Infrastructure Projects

APS agrees with Commission Staff that the Commission should not, as a general matter, actively endorse specific infrastructure projects in the abstract, *i.e.*, without a specific proposal in front of it. Instead, APS believes that the Commission should foster an environment that encourages developers to consider a wide range of projects for Arizona. One means of doing that is to implement an appropriate and specific pre-approval process for the contractual commitments needed to be made by the utilities regulated by the Commission, as discussed further below.

D. General Commission Approach

APS agrees with each of the points stated by Commission Staff regarding a general Commission approach to addressing natural gas infrastructure needs in Arizona. As APS discussed in its initial comments, and as Staff notes in the Strawman, under the Natural Gas Act, 15 U.S.C. § 717c(a), FERC has jurisdiction over “the transportation of natural gas in interstate commerce.” Under that Act, therefore, FERC is primarily responsible for siting, certification, development and regulation of most natural gas pipelines and storage facilities. Therefore, the Commission’s actions with respect to natural gas infrastructure need to complement and, where possible, support FERC’s activities for infrastructure development. For example, the Commission’s ongoing involvement in the FERC proceedings relating to the El Paso pipeline has been important in representing the interests of Arizona.

APS also supports an ongoing dialogue between Arizona utilities and the Commission regarding the development of natural gas infrastructure and agrees that the best means for the Commission to foster natural gas infrastructure development is through the timely implementation of guidelines, as well as a recovery mechanism, for addressing prudently incurred costs. APS will participate in any process that the Commission establishes for formulating those guidelines and process.

E. Cost Recovery/Review

As the Commission heard from essentially all interested parties through comments and at the September 10 workshop, an essential element of natural gas infrastructure development is an expedited approval process for cost recovery. A number of pipeline and storage projects have been proposed for Arizona that would address the state’s need for additional infrastructure. However, the developers of those projects cannot commit the capital for the projects without firm contractual commitments from regulated utilities to guarantee a stream of revenue to cover their development, construction and operating costs. The regulated utilities that would be customers for those projects, however, are hesitant to make such significant commitments without some assurance that their costs for the contracts will be recoverable, even if they have identified a long-term need for such projects. This is especially true when the assumptions that customers have to rely on to make such decisions, such as forward gas market prices, load projections and transportation rate escalations on existing pipelines, are subject to their own inherent uncertainty.

APS therefore believes that Commission establishment of a recovery policy for prudent costs and an expedited process for obtaining pre-approval of projects and contractual commitments would encourage the development of the needed infrastructure for Arizona. Such a process should allow not only for pre-approval of the up-front costs of development, however, but also for the pre-

approval of the long-term contracts that the utilities will be required to enter into. For example, APS has been evaluating the contractual commitments for the development of an additional pipeline in Arizona. Although there likely would be no or minimal up-front costs for APS, the Company would be required to make a commitment for a specified capacity on the pipeline, creating the obligation for future transportation payments to the new line owner upon completion of construction. A similar commitment would be required for natural gas storage. It is possible that those contractual commitments may be higher in the short term due to the need for the developer to recover its costs (which are in current dollars), even though the costs may be lower in the long term or offer additional benefits, such as increased reliability or access to additional, lower cost basins. APS firmly believes that any recovery process implemented by the Commission also needs to address the recovery of such costs. Through the pre-approval process, the Commission can determine whether the recovery sought should be address by placing them in rate base or by including them in a purchased power and fuel adjuster.

APS believes that any process adopted should:

- i) Specify the steps required to obtain pre-approval of rate treatment for a project or a contractual commitment;
- ii) Clearly state the key factors that the Commission will rely upon in conducting its review of a request for pre-approval;
- iii) Adopt the recommendation in the Staff Strawman, *i.e.*, that the standard for determining prudence is what the applicant(s) knew, or reasonably should have known, at the time of the application;
- (iv) Provide assurance to the applicant that once a project or contractual commitment is approved by the Commission as meeting the requirements for pre-approval, recovery of the reasonable costs of approved projects or contractual commitments will not be revisited by the Commission; and
- iv) Provide for prompt regulatory review and approval.

For example, a utility could submit an application to the Commission for pre-approval of contractual commitments. The applicant would provide to Staff, on a confidential basis, the following information for review: (a) an analysis of the applicant's needs on a projected basis, along with the underlying assumptions supporting that analysis; (b) an overview of the options considered by the applicant; and (c) the analysis supporting the contractual commitment for which the applicant seeks pre-approval. Staff would then issue a report recommending whether the Commission should approve the contractual commitment and the application would then go before the Commission in open meeting for approval.

APS strongly believes that, due to the timing concerns, the period between application to open meeting should be no more than 90 days. If the process were to take longer than that, utilities could be required to forego potential opportunities where long-term commitments must be made quickly or be lost.

F. Individual Utility Circumstances

APS agrees with Commission Staff that individual circumstances will govern which approach works best for each utility and that different utilities may achieve diversity through varying means. For example, because of APS' size, location, needs and operating parameters, APS has been actively considering various projects.

G. Reporting Requirements

As APS stated in its initial comments, the Company believes that the reporting requirements already established by the FERC and the Commission should be sufficient for new natural gas pipelines and, perhaps with minimal changes, for new storage projects or LNG terminals. APS agrees with Commission Staff that any new reporting requirements that may be adopted should be consistent with the current reporting requirements. APS encourages the Commission to ensure that any such new reporting requirements are not duplicative or unduly burdensome.