

NOTICE OF INQUIRY ON NATURAL GAS INFRASTRUCTURE ARIZONA CORPORATION COMMISSION

SOUTHWEST GAS CORPORATION COMMENTS ON “STRAWMAN” PROPOSAL AND WORKSHOP DISCUSSION

Introduction

On April 15, 2003, the Arizona Corporation Commission (Commission) Utilities Division Staff (Staff) initiated a Notice of Inquiry (NOI) on the Commission’s Policy and Action on Natural Gas Infrastructure in Arizona. Southwest Gas Corporation (Southwest) welcomes the Commission’s attention directed to natural gas infrastructure in the state, and believes long-term planning and policy actions regarding this matter will be beneficial to the residents of Arizona, as well as the energy industry.

As part of its approach in pursuing the NOI, Staff gathered information from various parties, including Southwest, and developed a “strawman” proposal. The “strawman” proposal was presented by Staff at a workshop held in Phoenix, Arizona on September 10, 2003. Southwest attended that workshop. As part of the follow-up to the workshop, Staff requested written comments on the “strawman” proposal, as well as the workshop discussion by September 25, 2003. Southwest appreciates the opportunity to provide its comments on Staff’s “strawman” proposal and the workshop discussion. As a general proposition, Southwest’s comments which follow, correspond to the general topical outline of Staff’s “strawman” proposal.

Supply/Infrastructure Diversity

Southwest supports the concept of diversity in natural gas infrastructure, including both interstate pipeline and storage facilities. Southwest agrees that the Commission should encourage alternative natural gas supply options, including new interstate pipelines and natural gas storage facilities.

In considering supply option diversity, the Commission should recognize that all of these alternatives must be examined in terms of cost-effectiveness. Meaningful reduction in reliance on existing interstate pipeline capacity will likely necessitate redundant capacity in local transmission lines that could be costly. Nonetheless, Southwest supports, as a general policy, Staff’s concern regarding the “...current monopoly on interstate pipeline service...” and believes

development of cost-effective alternative natural gas supply and delivery options is a worthwhile goal.

Staff's proposal directs that "Arizona utilities should include natural gas storage as an integral component of their efforts to develop a diverse natural gas supply portfolio..." (emphasis added). Southwest shares Staff's interest in the potential promise of incorporating storage in utility portfolios, however Southwest is concerned that the above-referenced language, as written, could be construed as a directive for utilities to contract for storage services. Southwest does not believe that was Staff's intent, as the Staff proposal also underscores the fact that "...the Commission recognizes that each utility's circumstances and needs are unique and participation in natural gas infrastructure projects will vary accordingly." Any possible misinterpretation on this issue could be easily alleviated by modifying the storage statement to clarify that utilities should consider storage as an integral component in their resource planning efforts, but are not necessarily expected to contract for storage services if they do not best meet a utility's individual resource needs.

Supply/Infrastructure Planning

Southwest agrees that the planning horizon for natural gas infrastructure should be done on a long-term basis.

Southwest has planned and continues to plan for its natural gas infrastructure needs on a long-term basis. In calendar year 2000, Southwest, El Paso, Mesa, APS, and SRP met on several occasions and evaluated in detail the adequacy of El Paso's Arizona infrastructure. The parties concluded that it was adequate for four to five years, with two exceptions that APS and SRP subsequently pursued resolving.

Southwest has recently been in detailed discussions with existing and proposed interstate transmission and proposed storage facility owners about its needs in the future. Southwest will share its planning information with the Commission and to a significant extent will share information about its existing resources and anticipated additional requirements with others in order to facilitate the identification of synergies. The exchange of information may need to be limited to ensure these efforts do not raise any antitrust concerns, since some of the parties may be competitors. In the past, the exchange of information has been limited due to competitive concerns by some of the parties; therefore, participation may only work under a voluntary structure and even then, the data exchange may be limited.

Southwest would need additional information on the CATS approach to centralized planning to consider supporting such a structure for gas supply resources. As Southwest understands CATS, the participants simply share

information about needs and plans for their own “on-system” infrastructure so that synergies can be identified. Natural gas infrastructure issues, however, go beyond “on-system” matters and into the realm of the upstream gas marketplace (subject to anti-competitive issues). Consequently, a CATS approach may not be appropriate for evaluating gas infrastructure needs.

Similarly, more information would have to be collected about the conceptual Independent System Operator (ISO). The electric ISO concept provides for daily scheduling over a congested regulated network of transmission/distribution capacity. Specifically, the independence is related to the financial interest in various energy supplies, to ensure that a variety of suppliers are able to schedule into a competitive market. An ISO, in general, would not provide for long-term, centralized, on-system resource planning nor would it provide for upstream infrastructure planning.

Southwest is willing to consider and explore the concept of both the CATS approach and an ISO, but it believes a stated policy to establish these entities would be premature without further study and evaluation.

Commission Approach to New Natural Gas Infrastructure

Southwest agrees that the Commission, in general, should not endorse specific natural gas infrastructure projects. Southwest also believes the Commission should take a complementary, but active role in regards to FERC’s overarching jurisdiction on interstate pipelines and the attendant storage. Southwest is in strong support of open and on-going communications between itself and the Commission, as well as with other utilities, subject to the cautions enumerated earlier regarding anti-trust concerns. Finally, Southwest endorses and supports the adoption of informal guidelines at this time. This allows the Commission, and, in turn, the utilities, increased flexibility in a dynamic marketplace, as well as the ability to adjust the guidelines on a more timely basis in the future, as circumstances invariably change.

Cost Recovery/Review

As noted above, Southwest agrees with Staff’s proposition that the Commission not endorse specific infrastructure projects. This aversion to specific project endorsement, however, should not be construed to conflict with Staff’s proposal for possible pre-approval of up-front costs incurred by Arizona utilities participating in the development of natural gas infrastructure. This should be clearly elaborated in any informal guidelines.

Staff’s draft proposal contemplates a provision that “...the Commission will consider on a case-by-case basis the possible pre-approval of specific prudent

up-front costs incurred by Arizona utilities while participating in the development of natural gas infrastructure.” At the workshop, some concern was expressed that this proposal could inadvertently delay utility subscription to infrastructure projects, as the utilities pursue Commission pre-approval. Southwest does not share this concern.

Southwest believes that the prospect for pre-approval of certain infrastructure costs presents an excellent opportunity to ensure that utilities are pursuing portfolio resource decisions that are consistent with the Commission’s policy goals. While there remains some question as to the procedure and utility documentation that will be required to secure Commission pre-approval, Southwest is confident that an expedited process can be developed that will not delay utilities contracting for additional infrastructure. On a more pragmatic basis, the “open season” and precedent agreement mechanisms used by most purveyors of new infrastructure projects are wholly consistent with a simultaneous utility pursuit of Commission concurrence on major infrastructure decisions.

Several of the workshop participants noted that when third-party developers are pursuing new infrastructure projects, the initial development costs are normally borne by the project developers and not utilities or other potential project customers. Hence, it was implied that, perhaps, a pre-approval mechanism for "up-front costs incurred by Arizona utilities" may be unnecessary; Southwest disagrees and urges Staff to retain this provision of the draft proposal. While there may not be a need for such pre-approval of up-front costs when third-parties develop infrastructure projects, there may be significant infrastructure projects that Arizona utilities undertake directly themselves. In those cases, Commission pre-approval may be desirable. In fact, several such cases were referenced in the workshop, including SoCalGas and PG&E on-system storage resources and the initial development of the Iroquois pipeline. To the extent that the Commission may prospectively entertain pre-approving costs for utilities to undertake their own infrastructure development, the pre-approval mechanism incorporated in Staff's proposal should be retained.

Southwest is further encouraged by the policy position that Staff has drafted on the issue of natural gas infrastructure cost recovery. The importance of explicitly establishing the standard of prudence determination for utility actions in regard to the development and acquisition of gas infrastructure cannot be overstated. Given the directive provided in the proposed prudency standard, utilities should have an understanding of the documentation that may be necessary to make a showing to the Commission that they have acted in a reasonable and prudent manner.

To the extent that utilities contract for storage services from third-party storage providers, Southwest’s experience is that the costs of such storage service are

considered components of gas acquisition cost. These costs are afforded the same pass-through treatment as purchased gas and interstate transportation costs. As such, the costs of storage are accounted for in the appropriate regulatory balancing or deferral accounts. Southwest considers this to be the proper regulatory treatment for contract storage costs.

Rate base treatment of storage cost would be appropriate for a utility's investment in storage facility assets. Shareholders should be provided the opportunity to earn a return on their investment in storage facility assets, just as they do on other utility assets.

Individual Utility Circumstances

Individual utility circumstances may result in different resource planning decisions among utilities. These individual circumstances include variations in seasonal demands, different annual load factors, alternate fuel capabilities in electric generation, existing interstate pipeline capacity contract provisions, and unique rating agency credit/financial ratings or outlooks. In consideration of differences in these factors among utilities, Southwest supports Staff's acknowledgement that each utility's "...needs are unique and participation in natural gas infrastructure projects will vary accordingly."

Reporting Requirements

Staff, in its proposal, states that the Commission has traditionally required some form of reporting for gas purchasing activities. As the procurement of additional gas infrastructure, whether pipeline capacity or natural gas storage, is essentially equivalent to gas purchasing activities, Southwest concurs that reporting to the Commission (or Staff) is appropriate.

Southwest files an annual Gas Procurement Plan (Plan) in Arizona. In the Plan, Southwest reports on numerous gas supply and resource activities. The annual Plan filing would provide an ideal means of communicating Southwest's acquisition and disposition of pipeline capacity and natural gas storage to the Commission. Southwest concurs with the Staff proposal that the utilities and Staff should collaborate in the development of any additional or changed reporting format and content for natural gas storage activities.

Summary

In conclusion, Southwest supports the Commission's interest in establishing policy goals regarding natural gas infrastructure in this Notice of Inquiry. As demonstrated in the above commentary, Southwest is in general agreement with

the proposals incorporated in Staff's draft "strawman" proposal. Southwest has noted a limited number of modifications or clarifications that it believes would further refine Staff's proposal. Southwest looks forward to continuing to actively participate in the instant proceeding to ensure that the Commission's natural gas infrastructure policy goals are successfully met by Southwest for its Arizona customers.