

**ARIZONA CORPORATION COMMISSION**

**UTILITY DIVISION STAFF'S NOTICE OF INQUIRY (NOI) ON NATURAL GAS INFRASTRUCTURE MATTERS IN ARIZONA**

**May 30, 2003**

**Kinder Morgan, Inc.** )  
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**Kinder Morgan Energy Partners, LP** ) **Response to Notice of Inquiry**

On April 15, 2003, the Staff of the Arizona Corporation Commission (“Commission”) published a Notice of Inquiry (“NOI”) on the issue of the Commission’s policy and action on natural gas infrastructure matters in Arizona. The purpose of the NOI is to solicit comments and suggestions to assist the Commission as it addresses natural gas infrastructure issues in the future. The major areas of inquiry are natural gas storage facilities and interstate pipelines. The Staff requested that such comments and suggestions be submitted on or before May 30, 2003.

As a general matter, the Kinder Morgan, Inc. and Kinder Morgan Energy Partners, LP (“the Kinder Morgan entities”) believe the Commission should implement flexible regulatory policies that encourage utilities to proactively assess competitive transportation and storage service alternatives to prudently and effectively meet their gas transportation and gas supply needs. Policies which encourage consideration and use of competitive infrastructure alternatives by Arizona utilities can provide such utilities with effective tools with which to diversify their gas supply portfolios in a safe, reliable, flexible and cost-effective manner. The Commission’s policies should allow for each utility to acquire such services in a manner that fits its individual needs. Utilities should be held to reasonable standards of prudence by the Commission, and should be provided the opportunity to work with the Commission to develop adequate and cost effective plans for pre-approval by the Commission. In this manner, the Commission’s policies should serve to provide a measure of certainty to utilities, natural gas consumers and other stakeholders. A project such as Kinder Morgan’s proposed Silver Canyon pipeline presents an alternative that can reliably provide Arizona utilities with access to

competitively priced natural gas supplies from the San Juan and Rocky Mountain Basins. The Kinder Morgan entities believe the Commission should act in an expeditious manner so that utilities and consumers of natural gas in Arizona can reap the benefits of access to and use of such competitive alternatives as soon as possible.

The following specific comments and suggestions are provided by the Kinder Morgan entities for the Commission's consideration on these matters:

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

A. Utilities in Arizona should be encouraged through formal Commission policies to explore the use of natural gas storage and associated transportation services for purposes of meeting their market needs. The Commission's policies should act to encourage utilities to prudently acquire storage and associated transportation services that are reliable and cost effective, while enhancing utility options with respect to access to diverse gas supplies. Utilities should be allowed to propose plans to acquire such services that meet their individual needs, and those utilities should be allowed to seek and obtain pre-approval from the Commission of such plans, upon demonstration that such plans provide prudent benefits to the utilities' customers. Once a utility's plans for storage services are approved, it should be allowed to propose modifications to such plans in response to rapidly changing market dynamics. Each individual utility should be given the opportunity to structure such plans within a flexible regulatory framework, and to work with the Commission to achieve cost-effective benefits that will flow through to the utility's customers.

**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.**

A. No. Generally, the utilization of natural gas storage services by any given utility would necessarily mean that the utility has a variety of peaking, price volatility control, and/or service flexibility needs that it is trying to meet. Hence, the utility will generally contract for the particular storage service(s) that will meet its needs. Such storage services, although tailored to meet the different needs of particular utility customers, all carry a cost to the utility. Such costs should be treated fairly and expeditiously, and if the utility has proceeded to acquire such storage services prudently in accordance with its overall gas supply planning needs, then such costs should be readily and fully recoverable from customers through the utility's rates. The

Commission should develop flexible policies that allow for each utility to acquire appropriate storage services to fit its needs.

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

- A. The Commission's policies should allow utilities to seek pre-approval of plans to acquire natural gas storage services such that utilities can proceed with some measure of certainty in meeting their gas supply needs. Such policies should recognize the importance of reliability, flexibility and cost effectiveness of the transportation service requirements necessary to effectively utilize such storage services. The Commission should provide for a readily available mechanism of full cost recovery, responsive to changes in markets, for utilities to use to address prudently incurred costs associated with acquired storage and associated transportation services obtained to meet their customers' needs. The Commission's policies should provide the opportunity for utilities to negotiate services and rates that will meet their individual needs.

**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?**

- A. The Commission should provide for a readily available mechanism of cost recovery, responsive to changes in markets, for utilities to use to address the prudently incurred costs of storage and associated transportation services obtained to serve their customers. All of the utilities' prudently incurred costs should be considered for full recovery through the utilities' rates. Further, the Commission could also consider specific incentive based or performance based rate mechanisms with which to encourage utilities to proactively evaluate competitive storage and associated transportation alternatives with respect to gas supply portfolio management and planning.

**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.**

- A. Utilities should be encouraged to acquire storage services and associated transportation, based upon the utilities' individual needs. Storage services can provide advantages to utilities by generating opportunities ranging from competitive prices, price volatility management, and enhanced flexibility to utilize competitive options

with respect to management of gas supply to meet peaking needs. Notably, the benefits of storage for utilities and end-users hinge on the reliability and cost-effectiveness of the associated transportation. Many individual factors contribute to the basic need for regulatory policy flexibility on storage and associated transportation, such that utilities may act prudently, within flexible regulatory guidelines, to acquire the services needed to perform reliably on behalf of customers.

**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?**

- A. Utilities should be allowed to propose timely and responsive plans, which may include storage services and associated transportation, to meet their individual market needs. Customer costs are not only driven by the prudent decisions of utilities. Often times, excessive regulatory oversight and restrictive regulatory policy and programs that allow precious little flexibility, lead to additional costs to consumers. In any event, the Commission should not burden utilities with excessively restrictive regulatory policies concerning storage and associated transportation services. Utilities should be held to reasonable standards of prudence by the Commission, and should be provided the opportunity to work with the Commission to develop adequate and cost effective plans concerning the acquisition of such services. Utilities should be allowed to gain pre-approval from the Commission of such plans, upon demonstration of the prudent nature of acquiring such services on behalf of their customers. One approach the Commission can consider to enhance customer benefits with consideration of minimizing costs would be performance or incentive based rate mechanisms. Such mechanisms can provide effective incentives for utilities to actively assess competitive infrastructure alternatives and to diversify their gas supply portfolios in a manner that provides mutual benefits for the utilities and their customers.

**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?**

- A. Financial hedging instruments and long term supply contracts are certainly measures that should be considered by utilities in developing their overall gas supply portfolios that they procure for customers. Although such measures are not necessarily intertwined with the acquisition of storage services, these measures can certainly be used in concert with storage services to form an overall supply portfolio. The Commission's policies should be sufficiently flexible so that these measures can be undertaken in an effort to meet the overall needs of

individual utilities. Storage services should be viewed by the Commission as an additional tool for utilities to use in their overall gas supply strategy; but should not be viewed as a requirement in order for utilities to effectively hedge or enter into long term contracts. Hedging and long term contracting can take many forms, most of which do not require the utility to have storage available at any given time. Once again, dependent on the individual needs of utilities, storage services may or may not provide a cost effective component of an overall gas supply plan. The decision to acquire storage services to be used in concert with other gas supply planning measures should be left to the utility. Such determination will necessarily be based on an individual assessment of such requirements by each utility. In this regard, flexible regulatory policy is paramount in order to allow utilities to make prudent decisions without regulatory uncertainty.

**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?**

- A. Yes. As a general matter, the benefits of access to and use of storage by utilities cannot be realized without adequate transportation capacity to meet the utilities' peak needs. Hence, utilities need to acquire firm transportation services commensurate with their level of contracted storage services such that they may adequately call upon storage and have transportation capacity available to bring the gas reliably to market. In this regard, the Commission should recognize the importance of reliable and cost-effective transportation alternatives when considering policies concerning storage infrastructure. Once again, the particular circumstances of individual utilities will play a key role in the determination of the different types of storage services and associated transportation the utility may wish to acquire to meet its needs. Further, it is not always necessary, given the flexibility and reliability of certain interstate pipeline firm transportation services, for the utility to purchase storage services in conjunction with transportation services. Kinder Morgan's Silver Canyon pipeline project, for example, will provide shippers with flexible service options that will provide utility shippers with a more cost effective means of reliability, without storage having to be acquired separately. This Silver Canyon project will allow shippers to receive firm transportation service at variable hourly rates of flow that significantly exceed the ratable hourly flows which are characteristic of typical firm transportation services.

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

- A. One option the Commission could consider with respect to the evaluation of utilities' use of natural gas storage would be a periodic requirement concerning submittal by the utilities of a gas resource plan. In such gas resource plan report, the utility would describe its plan for purchases of gas commodity and interstate transportation and storage services (and associated pricing) needed to meet the forecasted demand for service during the upcoming annual period. In addition, such report would include a description of how the utility plans to manage its gas supply portfolio, such as the degree to which the utility plans to utilize risk management tools (e.g., financial hedging instruments) to address price volatility. Such reporting requirement would allow for effective monitoring of the utilities' portfolio purchases, and can act as benchmarking tool for the Commission to assess actual purchase practices.

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

- A. Utilities in Arizona should be encouraged through formal Commission policies to explore competitive alternatives regarding interstate natural gas pipeline capacity for purposes of serving their market needs. Such policies should recognize the benefits to utilities and their customers of competitive interstate pipeline projects that can offer reliable, flexible and cost effective alternatives with which to expand their gas supply options and diversify their gas supply portfolios. For example, Kinder Morgan's Silver Canyon pipeline project can provide Arizona utilities with safe, reliable access to competitively priced natural gas supplies from the prolific Rocky Mountain and San Juan gas producing basins, and utilities should be provided with flexible regulatory policies that allow and encourage the utilities to utilize such projects. The Commission should provide for a readily available mechanism of full cost recovery, responsive to changes in markets, for utilities to use to address prudently incurred costs associated with acquired interstate pipeline transportation services. Utilities should be allowed to contract for interstate pipeline services in a manner that is not the result of a generic policy, but that is individually tailored to fit their needs. Further, utilities should be allowed to gain pre-approval from the Commission of such plans, upon demonstration of the prudent nature of acquiring such services on behalf of their customers. Once a utility's plans for interstate pipeline services are approved, such utility should be allowed to propose modifications to that plan in response to rapidly changing market dynamics.

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

- A. Utilities should be encouraged to acquire interstate pipeline capacity that can provide reliable, flexible and cost effective service alternatives to meet their individual needs. The Commission's policies should demonstrate a commitment to new interstate pipeline infrastructure through support of pipeline alternatives such as Kinder Morgan's Silver Canyon pipeline project. Utilities should be encouraged to contract for service on competitive pipeline alternatives such as Silver Canyon as a means with which to diversify the mix of overall gas supplies to the benefit of end users. Utilities should be able to act prudently, within flexible regulatory guidelines, to acquire the interstate pipeline services needed to perform reliably on behalf of customers. Once again, one approach the Commission can consider to reduce the cost of natural gas service to consumers in Arizona would be performance or incentive based rate mechanisms. Such mechanisms can provide effective incentives for utilities to actively assess competitive interstate natural gas pipeline alternatives and to diversify their gas supply portfolios in a manner that provides mutual benefits for utilities and their customers.

**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?**

- A. The Commission should not try to engage in a specific ordering of the relative importance of such goals as part of a generic assessment of the appropriateness of the use of interstate pipeline facilities and services by utilities, but rather should assess their relative importance in the context of a case-by-case analysis of particular utility proposals. For example, while reliability is of paramount concern in all cases, certain circumstances particular to a given utility may place a premium on operational flexibility as opposed to other considerations. Ultimately, it is the entire package of operational and service attributes applicable to a particular interstate pipeline transportation alternative that should be recognized by the Commission as an attractive transportation option for Arizona's utilities. The Kinder Morgan entities strongly believe that the Silver Canyon pipeline project can effectively address the operational and service needs of Arizona's utilities.

**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?**

A. Yes. The Commission's policies should encourage utilities to proactively assess competitive pipeline options with which to prudently and effectively diversify their transportation and gas supply portfolios. Competitive alternatives such as the Silver Canyon pipeline can provide flexible, cost-effective transportation and access to relatively low cost natural gas supplies while increasing the reliability of service. Continued reliance on a single interstate pipeline for all pipeline capacity is untenable in light of the current regulatory environment in the southwest concerning access to and use of interstate pipeline capacity. Moreover, it is the natural gas consumers in the state of Arizona that will ultimately reap the benefits from Commission policies that encourage utilities to diversify their sources of interstate pipeline capacity.

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

A. The Commission should support the notion of a diversified supply portfolio to the extent such initiatives encourage utilities to seek and take advantage of competitive alternatives. As such, the concept of a diversified supply portfolio should generally be supported.

**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?**

A. The Commission's policies should serve to foster the development of new competitive pipeline and storage infrastructure. Generally, the Commission's policies should act to openly encourage utilities to acquire capacity from competitive interstate pipeline and storage alternatives to meet the particular needs of the utilities. More specifically, the Commission should actively support interstate pipeline and storage projects to the extent such projects provide safe, reliable, flexible and cost-effective natural gas transportation/storage alternatives for the state's utilities and natural gas consumers. The Commission should strongly consider those interstate pipeline alternatives that provide access to competitively priced natural gas supplies and producing basins that provide enhanced opportunities for utilities to diversify their natural gas transportation and gas supply portfolios. In this regard, competitive alternatives such as Kinder Morgan's Silver Canyon pipeline project should be given favorable consideration by the Commission in light of the significant benefits that such alternatives can bring to Arizona utilities by addressing the key concerns of reliability, operational flexibility, portfolio diversity and cost.

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

- A. Other natural gas infrastructure issues the Commission should address to encourage the development of new storage and transportation projects in the state of Arizona would be to provide tax incentives. For example, lower Ad Valorem Taxes would help encourage new storage and interstate pipeline infrastructure to be built. By encouraging tax relief for new pipeline projects in the state, the Commission can serve the joint purpose of a higher tax basis without higher tax rates.

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

- A. Given the current environment surrounding natural gas infrastructure and pipeline capacity issues in the southwest, it is critical that the Commission act expeditiously to initiate and implement policies that serve to promote the development and use of competitive storage and interstate pipeline alternatives. Given this, and the fact that the Commission is already well versed and knowledgeable with respect to the issues surrounding natural gas infrastructure, the Kinder Morgan entities do not believe that workshops are appropriate. In fact, workshops may only postpone the potential benefits of such policies to Arizona's utilities and natural gas consumers. Further, timely Commission action concerning the development of such policies is paramount in light of the long lead times associated with storage and interstate pipeline projects.

Respectfully Submitted,

Kinder Morgan Inc.  
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