

**Response of Wellton-Mohawk Generating Facility to
Arizona Corporation Commission Notice of Inquiry on Natural Gas Infrastructure Matters
in Arizona**

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

Yes. One of the most critical issues for energy businesses in Arizona, whether gas or electric utilities, or gas-fired generators, is the future development of natural gas storage facilities and pipeline infrastructure that could help support ongoing energy operations. The benefits of natural gas storage can be considerable, particularly given pipeline capacity issues facing Arizona natural gas users in recent times.

The Federal Energy Regulatory Commission ("FERC") has jurisdiction over the approval and pricing of gas storage facilities, however, the Arizona Corporation Commission ("Commission") can take an active role in FERC proceedings, to ensure that the interests of Arizona businesses and consumers are properly represented. The Commission could also develop informal policies regarding the use of natural gas storage by Arizona utilities, although existing, or modified policies regarding purchased gas adjustment and fuel cost recovery would be the most effective means of support for use of these resources.

The role of natural gas storage in the resource portfolios of Arizona utilities, or gas-fired generators, should be solely a utility management decision, however the Commission can encourage development of natural gas storage facilities for the whole natural gas industry by providing adequate flexibility in its purchased gas adjustment and fuel purchase recovery policies for gas and electric utilities to recover prudently incurred costs of natural gas storage. Commission cost recovery policies should consider the individual characteristics of each utility relative to any policy directives, as the use of gas storage is dependent upon the utility's individual load factor.

Underground storage typically is used to meet gas capacity and/or commodity requirements, provide a physical option for gas commodity, serve to back-up existing gas supplies, and meet operational swing requirements. For the gas-fired generation sector, storage, especially high deliverability storage, can help manage its dispatchable and peaking sales operations to minimize its overall fuel procurement costs. Storage can also provide reliability to a generators' operation.

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.

No. Natural gas storage usually plays different roles in the operational and risk management activities of gas and electric utilities, but there is no reason to treat them differently. The key issues important for further development of natural gas storage in Arizona relate to the ability of gas and electric utilities to recover prudently incurred costs related to gas storage contracts, ongoing usage of storage facilities, and any associated pipeline capacity.

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

In determining policy on natural gas storage, the Commission should take into account the burgeoning demand for natural gas that has and is continuing to emerge in Arizona. Gas storage is part of the natural gas delivery system and to the extent storage adds to reliability of the delivery system or results in reduced costs for gas users, it should be positively supported. Continuing to understand the role storage can play in meeting the requirements of the gas-fired generation sector and the types of storage products and resources most capable of serving the interests of the electric generation and other gas customers, would also be viewed as important first steps.

Among other issues that should be considered by the Commission in creating any policy on natural gas storage include 1) consistency with the existing responsibilities and jurisdiction of various parties, including the Commission, utility management, and FERC, as discussed in Question 1 above; 2) ongoing costs of policy oversight, as well as the potential for duplication of efforts if responsibilities of these entities overlap in any way; 3) measures that allow the Commission to use its existing purchase gas adjustment or fuel purchase review process to accommodate utilities' recovery of costs incurred to contract for natural gas storage, and to utilize that storage once it is developed.

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?

Gas storage is simply another resource available to gas utilities and gas-fired generators to meet their service obligations. From the perspective of FERC, natural gas storage is regulated in the same way as interstate pipelines. When developed under federal jurisdiction, the rate design for underground storage consists of fixed and variable charges, and the services are provided pursuant to an approved tariff. The Commission should ensure that its respective gas cost and fuel purchase recovery mechanisms for both gas and electric utilities allow the recovery of prudently incurred costs for underground storage, usage of storage on an ongoing basis, and the cost of the gas stored and withdrawn.

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.

Natural gas storage can assist gas and electric utilities, as well as gas-fired generators, in reducing overall delivered costs of natural gas supplies, and in improving the reliability of natural gas delivery. Through ongoing use of natural gas storage, it is possible for these entities to minimize peaks and valleys of natural gas purchases, which could ultimately reduce natural gas price volatility.

Rather than encourage development of a specific resource, the Commission should not preclude utilities from contracting for gas storage to mitigate price volatility, enhancing the reliability of existing gas supplies and capacity, meeting incremental fuel requirements, or other portfolio goals. All of these goals have value and should be pursued, and the relative values change over time with load and market conditions.

In addition to reducing the cost of delivered natural gas to consumers in AZ and adding to the reliability of the pipeline system, storage can and has been used by parties in other jurisdictions for price arbitrage purposes. While cost reduction and improved reliability are the subject of general public policy consideration, how storage is used and for what purposes should be left up to the individual storage subscriber. Storage has and will be operated as part of the natural gas delivery system and decisions as to how such asset is utilized should be left to the contracted parties holding such asset.

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?

Customer benefits are often measured by the average cost of gas or fuels, which is consistent with minimizing the cost to customers. These objectives are met through the Commission's periodic reconciliation of fuel costs. Given the "lumpiness" of capacity additions and volatile gas prices, these benefits and costs should be measured over time and short-term evaluations should be avoided.

The Commission should keep in mind that underground storage facilities often have specific operating requirements, which can lead to gas being withdrawn, injected, or left in place despite a lower cost alternative being available at a point in time. Ensuring that Commission policies on gas cost and fuel purchase recovery are sufficiently flexible to address any gas or electric utility issues related to storage utilization could ultimately reduce the overall cost of natural gas delivery, including interstate pipeline transportation costs.

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 gas can be an important component of a gas or electric utility's, or gas-fired generator's, gas supply portfolio. The flexibility provided by storage can allow the entity to utilize lower cost gas, rather than rely on the spot market. In this way, gas storage is a physical call. Depending on the role played by storage in a portfolio and the accounting methods selected by the Commission, underground storage can take on many functions, including a call option, a fixed price supply, or an insurance policy.

Use of financial tools, such as caps, collars, or futures contracts can also be effective ways of mitigating portfolio price risk. But like storage, these tools are not without cost. Further, holding financial positions often require that margins be paid between the counterparties to limit exposure. Holding gas in storage does not typically require margin, but depending on the Commission's accounting policies, could affect a utilities' short-term debt requirements and the way short-term interest is expensed or accrued.

While the use of a physical hedge, such as storage, or a financial hedge, such as a cap or collar, does not directly impact market price volatility, it can soften the effect of market volatility on the cost of the utilities' or generators' fuel by providing alternatives to spot market prices.

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?

There is a relationship between natural gas storage and pipeline capacity. The mix is defined by a utility's load factor, relative costs of pipeline and storage, and expected volatility of gas prices. When included in a resource portfolio to meet capacity and commodity requirements, natural gas storage should allow the gas or electric utility, or gas-fired generator, to reduce required levels of interstate pipeline capacity needed during peak periods, therefore reducing pipeline transportation costs, assuming the storage field is proximate to the utility or gas-fired generator. During non-peak periods, the interstate capacity would be used at a higher load factor to re-fill storage. The Commission should evaluate this relationship through its existing portfolio review/planning process. In addition, the Commission should ensure that its policies adequately address prudence standards and policies, particularly in maintaining separation between the decision to contract for storage and the subsequent operation of storage.

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

From an operational perspective, the Commission has no need to undertake a role in monitoring, reporting, or evaluating Arizona utilities' use of natural gas storage. However, recovery of costs of natural gas storage would fall under Commission jurisdiction through utilities' existing purchase gas adjustment and fuel purchase recovery mechanisms.

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?

One of the most critical issues for energy businesses in Arizona, whether gas or electric utilities, or gas-fired generators, is the future development of natural gas storage facilities and pipeline infrastructure to support ongoing and expected energy operations.

The benefits of additional interstate pipeline options in the Southwest can be considerable, particularly given the pipeline capacity allocation issues facing Arizona natural gas users, and the projected increase in gas demand across the Southwest. While the use of interstate pipelines by Arizona utilities should be solely a utility management decision, the Commission can encourage development of interstate pipelines through its purchased gas cost and fuel purchase recovery policies. For example, encouraging the development of pipeline capacity (and allowing the recovery of associated demand charges) could serve to reduce regional capacity constraints and put downward pressure on the spot price of gas delivered to Arizona markets.

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 service in Arizona?

The use of interstate pipelines is driven by a number of factors, including pipeline rates, delivered gas prices, market prices for electricity, demand for natural gas, and availability of natural gas and electric transmission capacity. Enhancing reliability typically comes at a cost, particularly if the Commission determines that reliability requires diverse and possibly redundant capacity. Reliability is insurance, and insurance comes at a price. Given the fixed costs of pipeline capacity, costs are reduced as the capacity is used at a higher load factor, which tends to diminish reliability. To balance these competing objectives *over time*, the Commission should encourage pipeline capacity additions by utilities that minimize the average cost of gas over time, subject to the Commission's reliability objectives. In addition, the Commission policies regarding cost recovery could assist utilities as they consider future commitments for interstate pipelines currently proposed that would help ensure ongoing development of additional interstate pipelines in the Southwest.

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?

Both gas and electric utilities should make their own determination as to the levels of reliability, cost, portfolio diversity, and operational flexibility regarding use of interstate pipeline facilities that best meets their needs and results in the lowest costs, over time, for their customers. This is a normal part of the utility planning process. The Commission could periodically review these portfolio plans. The Commission should make its determination as to the prudence of costs incurred as a result of its decision to purchase interstate pipeline transportation capacity in ongoing purchase gas cost and fuel purchase recovery proceedings.

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?

Please see response to Question 12, above.

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

Please see above responses.

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

FERC oversees review and approval of proposed new pipelines, expansions of existing pipelines, and storage facility development. If it thinks it necessary, the Commission should intervene in certificate applications to ensure that Arizona's interests are represented. At the State level, the Commission's role is to review the prudence of costs incurred as a result of utilities' decisions to acquire capacity through existing purchase gas adjustment and fuel purchase recovery proceedings. Through balanced Commission review and cost recovery policies, the market will support projects that meet the needs of gas and electric utilities, and gas-fired generators.

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

Not at this time.

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

Given current circumstances, including multiple proposed interstate pipeline projects, proposed natural gas storage facilities, and ongoing El Paso pipeline capacity proceeding, the Commission may find it important to hold one or more workshops to further discuss and understand natural gas storage and interstate pipeline issues, and to keep abreast of current development. The Commission should set forth an agenda identifying the issues it believes need to be addressed. All parties, including the gas-fired generators, could benefit from the collective knowledge gained through such an undertaking.