

GALLAGHER & KENNEDY

P. A.

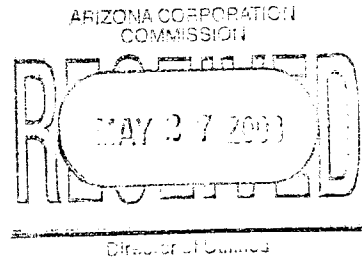
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May 21, 2003

Robert G. Gray
Arizona Corporation Commission
Utilities Division
1200 West Washington
Phoenix, AZ 85007



Re: AEPCO's Responses on Natural Gas Issues

Dear Bob:

On behalf of the Arizona Electric Power Cooperative, enclosed are its responses on the Natural Gas Infrastructure Notice of Inquiry. If you have any questions, please call.

Very truly yours,

GALLAGHER & KENNEDY, P.A.

A handwritten signature in black ink that reads "Mike".

By:
Michael M. Grant

MMG:bo
Enclosure
10421-0001/1103585v1

cc with enclosure:

Robert Hewlett
Patricia Cooper

AEPSCO'S RESPONSES TO THE NOTICE OF INQUIRY ON NATURAL GAS INFRASTRUCTURE MATTERS

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

The Commission should encourage the development of storage projects that would benefit the citizens of Arizona to be used as a supply and cost mitigation tool, particularly for those served by jurisdictional electric utilities (EU) or local distribution companies (LDC), whose natural gas transportation needs are provided primarily or entirely by El Paso Natural Gas Company (EPNG). Further those EU's and LDC's should be encouraged by the Commission to participate in such storage programs if justified by economics or operational considerations. Formal, mandatory guidelines promulgated by the Commission may tend to impart varying degrees of undesirable rigidity while an informal policy of encouraging participation and providing for recovery of reasonable costs of such participation might be more effective. For example, the considerations and utilization patterns for an EU using storage may very likely be different than for a LDC. The Commission may want to informally encourage storage, but rely on good utility practice employed by the LDC's and the EU's to implement it.

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.

Yes. As indicated above, the circumstances justifying the cost recovery of storage and usage patterns would be different for a winter peaking LDC than a summer peaking EU. The LDC is more interested in actual supply to meet critical human needs requirements in the winter while the EU, aside from periods of peak demand when gas peaking units must be used, is more concerned with use of natural gas as a fuel and the resulting summer price swings.

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

The prospect of mandatory conversion from full requirements to fixed demand status now anticipated to occur on September 1, 2003 at levels below the actual, historic operational needs of the EU's and LDC's on the EPNG system - thereby all but eliminating flexibility for those gas serving or utilizing utilities - by the Federal Energy Regulatory Commission (FERC) is the fundamental issue necessitating storage projects. The Commission needs to recognize applicable F.E.R.C. jurisdiction, but not refrain from providing input. Other issues are presented in the context of the questions and answers which follow.

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?

All costs associated with gas storage, including, but not limited to, reservation, inventory, injection and withdrawal charges should be recoverable just as the wholesale cost of delivered gas is recoverable. As for cost recovery mechanisms, the Commission should consider adjustment clauses, periodic reviews or other devices which would allow timely cost recovery without the necessity of full rate cases.

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.

Yes, all of them. The relative importance of these uniformly important goals would vary with

the nature of the jurisdictional utility, the time of year and the operational status of electric generation units, with respect to EU's, as indicated in earlier responses. The bottom line for all jurisdictional utilities is that beneficial storage should be developed to assist in replacing lost full requirements availability and flexibility on the EPNG pipeline which is expected to occur.

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 should recognize that the cost of storage utilized in keeping with prudent utility practice is the price that may be required to be paid on behalf of Arizona retail customers to overcome the economic and operational constraints created by the FERC if it finally changes the status of most LDC's and EU's on the EPNG system from that of full requirements customers to customers with a specific contract demand quantity. Most of these companies have no other pipeline alternative.

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?

There are two objectives: availability of supply and cost of the product, resulting from the application of these available tools. Storage addresses both and accordingly should be universally useful under the right circumstances. The other tools, however, should be used, along with storage, in an overall strategy. The Commission might also consider adopting a policy on acceptable hedging practices and limits to assure cost recovery.

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?

That relationship has already been addressed in several prior responses. The Commission should continue its strong advocacy for the cause of Arizona's consumers recognizing the political realities of the situation.

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

The Commission ought to be a proactive advocate of the installation of natural gas storage and its use by jurisdictional utilities in Arizona. Annual summary reports detailing storage use could be submitted by the jurisdictional utilities.

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?

It is difficult to imagine what new policies might be useful other than the commitment to continue to work with the jurisdictional utilities in their struggles with EPNG in the various FERC proceedings. FERC should be encouraged to pay more attention to the needs of captive customers on pipeline systems and less attention to the needs of the pipelines and customers who have competitive choices. It should be stressed that the participation of the Commissioners and ACC Staff has, over the past several years, been very important and helpful - particularly as an effective offset to the involvement in those EPNG proceedings by the utility regulatory staffs of other states.

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?

Utilities currently served by EPNG are struggling with its high costs and diminished service. EPNG does not now offer storage service useful to Arizona utilities and should be encouraged to do so. Gas consumption in Arizona will continue to dramatically increase and, without meaningful remedies to our problems, costs will continue to escalate and reliability will diminish further. Additionally, EPNG has historically been unresponsive to the expressed needs of its captive customers or to solutions to problems those customers may suggest. EPNG's main focus appears to be profit maximization and responsiveness to customers with other options. Pipelines in competition with EPNG and storage projects should be encouraged and politically assisted to come into 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?

For utilities in the southern part of Arizona, the EPNG is only pipeline now in service. Others should be encouraged to come into the state. Accordingly, transportation portfolio diversity at present does not exist. However, in the future should alternative pipeline service become available, the Commission should encourage jurisdictional utilities to contract for service on both systems. As a result, costs may increase slightly in the near term, but they would diminish over time and reliability and operational flexibility would be increased, particularly if the new pipeline were to be connected to storage or if its presence would force EPNG to become competitive in other ways, including economically (from the customers' prospective), expanding its useful capacity and installing storage.

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 the prior response.

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

We agree with the Commission that economic diversity in fuel supply (coal/fuel oil/gas) is very desirable. Likewise, if two pipelines exist, along with an independent storage project, EU's and LDC's should be encouraged to contract for discrete elements of service from all of them, again consistent with good utility practice.

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?

The Commission should monitor, politically encourage and actively participate in such proposals. But, it would be optimal if dialogue and coordination among the Commission, its Staff and all affected jurisdictional utilities were to occur prior to the Commission adopting a final position on such proposals.

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

Other issues probably exist, but none come presently to mind.

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

Yes.

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