

Citizens Communications Company
Arizona Gas Division
Response to the Arizona Corporation Commission Utilities Division Staff
On the Issue of:
Arizona Corporation Commission Policy and Action on Natural Gas Infrastructure
Matters in Arizona

May 30, 2003

Citizens is pleased to be given the opportunity to provide input on potential Commission action on Arizona natural gas infrastructure. The industry will benefit to the extent the Commission is able to clearly articulate its expectations, policies, and standards of review on these matters before it moves forward into this key area. Citizens believes this Notice of Inquiry is an important initial step in that process. Following are Citizens' responses to the questions posed by Staff.

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

Citizens believes that the complexity of the issues surrounding the introduction of storage as an integral part of gas supply portfolio management makes it difficult, particularly at this stage, to establish a single set of formal policies that will be relevant to all Arizona utilities. For that reason, Citizens believes that, at least initially, the Commission should not develop "policies" per se, but rather move to introduce general guidelines intended to assist the affected utilities as they address the initial stages of implementing gas storage facilities and techniques. A set of more formal policies may be more appropriate after the Commission and the utilities have gained more experience with natural gas storage.

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.

From the perspectives of the overall cost and reliability in connection with the provision of utility energy services, whether in the form of electricity or natural gas, the principles and attributes of employing gas storage are similar for both types of utilities. Both can achieve greater operational flexibility, higher service reliability, economic offset of interstate pipeline capacity needs, and enhanced ability to pursue market opportunities through the use of gas storage. While operational differences do exist with respect to the manner in which storage would be employed, there are also clear common underlying reasons why each utility type would employ storage. Consequently, from technical and economic viewpoints, it is reasonable for the Commission to view and treat

natural gas storage similarly for electric and gas utilities. A key difference to bear in mind, of course, is the relative importance of the fuel to each utility type. Natural gas storage may not be important or applicable to certain electric utilities with little dependence on natural gas as part of their generation fuel mix.

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

If the Commission's were to view gas storage from a traditional regulatory paradigm, its policy on natural gas storage would address matters such as: 1) the extent to which utilities are expected or encouraged to employ storage and of what type; 2) the basis for judging the prudence of the procurement of or investment in storage assets; 3) the basis for evaluating the prudence of the operation of storage assets; and 4) the equitable allocation of storage costs between regulated and non-regulated functions. If, however, it were the Commission's goal to stimulate the introduction of storage into supply portfolio management, a more productive approach might be to base its policy on providing positive economic incentives. Such an approach may in fact elicit more innovation, creativity, and balanced risk-taking by utilities. Under such an approach, the Commission's gas storage policy might address: 1) an articulation of the benefits to be achieved through the use of gas storage; 2) the structure of performance-based ratemaking needed to incent attainment of these goals; 3) the means to measure and monitor their attainment; and 4) an action plan for moving the process forward.

4. If Arizona utilities utilize natural gas storage, how should the Commission address recovery of costs for such storage and what costs should be considered?

The response to this question depends on whether it is the Commission's goal to stimulate storage development or to merely respond to the potential for Arizona utilities' to pursue such technology. In the latter case, storage costs should be treated no differently than any other utility investment or expense: utilities should be afforded the reasonable opportunity to recover all of their necessary, prudently-incurred costs of providing service through base rate or purchased-gas-adjustment filings with the Commission. If, however, it becomes the goal of the Commission to proactively stimulate the development of gas storage facilities and techniques to enhance the economy and reliability of the Arizona gas supply infrastructure, it should consider alternative mechanisms that provide clear incentives to companies that can successfully and effectively integrate gas storage into their operations. Such alternatives might, for example, take the form of cost recovery pre-approval, rate incentives for exceeding cost or performance benchmarks, or stockholder shared-savings mechanisms.

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.

It is the proper role of the Commission to encourage the pursuit by regulated utilities of technology that will enhance the reliability and economy of the gas supply infrastructure of Arizona. As one of the few states in the country with neither underground or liquefied natural gas storage facilities in place, gas storage appears to be a ripe area for potential development. While gas storage offers potential benefits relating to both economics and reliability, enhancement of physical reliability is perhaps the most important benefit to Arizona. Much of Arizona is captive to a single interstate pipeline for its supply of natural gas. Having natural gas storage available at key load centers for gas would be tantamount to having an additional source of supply that could be relied upon during system emergencies, helping to assure the uninterrupted flow of gas. The operational flexibility provided by natural gas storage (such as through its use to support imbalance management) not only offers significant potential economic benefits, but also helps to enhance the physical reliability of the gas delivery system. For example, if unanticipated high gas demands were to cause an overdraft on interstate facilities, existing tariffs may enable pipelines to limit gas deliveries. Use of storage in such circumstances can mitigate the threat of potential flow restrictions. Moreover, storage also provides economic benefits including mitigation of price volatility, creating the ability to take advantage of temporal price arbitrage opportunities, and the economic offset to interstate pipeline capacity (e.g. through peak-shaving). Arizona utilities should be encouraged to explore all of these potential benefits of gas storage.

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?

Citizens believes that, by enlisting the creativity and innovation of Arizona utilities through the introduction of positive incentives, the highest probability of providing the greatest value to customers (i.e. maximum benefits and minimum costs) can be achieved. Citizens submits that the choice of approach here is the single-most important policy decision for the Commission to make in this matter. Pursuing the traditional regulatory approach brings with it the need for the Commission to effectively dictate and manage the process (e.g. as with the electric IRP process); a decision to use an incentive approach can leverage a significant reservoir of industry talent and limit the Commission's key role to describing the outcome it wishes to achieve, establishing adequate performance incentives, and monitoring the process to its conclusion.

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?

The physical aspects of gas storage distinguish it most clearly from the other two cited methods of reducing price volatility. While financial derivatives and/or supply contracting provide a commercial commitment regarding gas price, volume, and delivery date, such agreements are generally subject to a higher degree of commercial and technical supply risk. Having physical gas in storage adjacent to load centers provides greater certainty that the actual volume of gas that was purchased at a known price can actually be delivered to the load.

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?

When ideally integrated into a utility's supply management system, use of gas storage can reduce the amount of interstate pipeline capacity rights a utility may be required to hold (e.g. through peak-shaving operation). However, this is not necessarily the case for all storage/pipeline facilities, depending on their relative location and operational considerations. The Commission should acknowledge that this general relationship exists, but defer specific consideration to a case-by-case analysis due to the many variables and circumstances that must be considered for each affected utility.

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

The response to this question depends on the policies ultimately adopted by the Commission with respect to encouraging the use of gas storage and the expected benefits it seeks to achieve. It may be more appropriate to address this question when further clarity has been developed in this regard.

10. Should the Commission develop formal or informal policies regarding the use of interstate pipelines by Arizona utilities?

Citizens believes that a definitive statement of Commission policy on interstate pipeline matters can help the industry with greater clarity of Commission expectations and a better understanding of the potential risks and benefits of pursuing interstate pipeline projects. Citizens strongly suggests that consideration of gas storage policy be done contemporaneously with the development of interstate pipeline policy, due to their inherent close relationship. Since experience with interstate pipeline use within Arizona is much more extensive than that of gas storage, it seems most sensible to begin the process of interstate pipeline policy development with the introduction of "general guidelines" such as what Citizens has suggested relative to

gas storage, again with the idea that more formal policies will follow as both areas are developed in parallel.

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?

One clear possibility to accomplish these goals is for the Commission to encourage the integration of storage into utilities' gas transportation development plans. As addressed above, storage ideally can both increase reliability and lower overall costs.

12. How should the Commission balance the goals such as reliability, cost, portfolio diversity, and operational flexibility as it considers the use of interstate pipeline facilities by Arizona utilities?

While portfolio diversity and operational flexibility can both provide cost and reliability advantages, this basic question is one of establishing a proper balance between reliability and cost. Given its traditional role, the Commission should develop reliability standards relative to natural gas infrastructure and then challenge the utilities to achieve such standards at the lowest reasonable cost. As previously stated, Citizens believes that the superior way to accomplish this is to positively incent Arizona utilities to achieve these goals.

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?

Clearly a diversified pipeline capacity portfolio is theoretically superior to reliance on a single pipeline. However, for many areas of the state, this is far "easier said than done," due to cost considerations. This question begs for the striking of a proper balance between the desired degree of service reliability and the attendant costs. While the Commission can encourage pipeline diversity, it is not entirely clear to what extent it can be practically achieved across Arizona in the relative near term. Arizona can benefit in the long term by having a diversified interstate pipeline infrastructure in place, and Citizens believes it is reasonable for the Commission to put in place the incentives to attain this long-term goal in a cost-effective manner.

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

Natural gas supply diversity is theoretically achievable through a variety of factors including suppliers, supply basins, term of supply agreements, the nature and term of interstate pipeline and storage capacity rights, and even the degree of vertical integration into the supply chain. In Citizens view, it should not be the role of the Commission to dictate or “apply” these concepts to the Arizona gas industry. Instead the Commission should seek to define the end results it wishes the industry to achieve and to put in place a performance-based incentive system for achieving these objectives. The degree and nature of supply diversity needed to accomplish the objectives should be left to the industry to work out.

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?

To the extent the Commission can create a business environment in Arizona where development and expansion of natural gas transportation infrastructure can proceed in a safe, economical and effective manner, it will provide a great service to the gas-consuming public. Rather than addressing specific projects, Citizens believes that the ideal role of the Commission would be to explore the institutional or legal obstacles that may be impeding infrastructure development and seek ways to remove these barriers. Addressing particular proposals for pipelines or storage facilities should be matters left to the Arizona gas industry to work through.

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

Rather than by addressing particular issues, Citizens believes that establishing guidelines, standards, and expectations concerning gas transportation infrastructure and a framework of incentives for their achievement would be the most effective way for the Commission to address this matter.

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

Yes, Citizens believes further workshops could help define the best ways for the Commission to proceed on these matters.