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BEFORE THE ARIZONA CORPORATION COMMISSION

- MARC SPITZER
Chairman
- WILLIAM A. MUNDELL
Commissioner
- JEFF HATCH-MILLER
Commissioner
- MIKE GLEASON
Commissioner
- KRISTIN K. MAYES
Commissioner

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR PRE-APPROVAL OF COST RECOVERY FOR PARTICIPATION IN THE KINDER MORGAN SILVER CANYON PIPELINE PROJECT) DOCKET NO. E-01345A-04-0273)) DECISION NO. _____)) <u>ORDER</u>)
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Open Meeting
August 31 and September 1, 2004
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. Arizona Public Service Company (“APS”) is engaged in providing electricity service within portions of Arizona, pursuant to authority granted by the Arizona Corporation Commission (“Commission”).
2. On April 9, 2004, APS filed for Commission pre-approval of cost recovery for participation in the Kinder Morgan Silver Canyon pipeline project. APS has provided certain information to the Commission pursuant to a confidentiality agreement.
3. The Silver Canyon pipeline project is a proposed new pipeline which Kinder Morgan Energy Partners would build from the San Juan supply basin in northwest New Mexico to Phoenix and then to the California border at Ehrenberg, Arizona.
4. APS’ filing is pursuant to the Commission’s on-going Notice of Inquiry on Natural Gas Infrastructure (“NOI”), which the Commission initiated in April, 2003, to consider issues related to natural gas infrastructure and their impact on natural gas service in Arizona.

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1 5. On August 16, 2004, Staff filed its Staff Report in this matter, containing Staff's
2 evaluation and recommendations regarding this APS filing. A confidential and a redacted version
3 of the Staff Report have been put forth.

4 6. Traditionally, Arizona shippers had received virtually all of their natural gas service
5 on the El Paso Natural Gas ("El Paso") pipeline system. A small amount of service in northern
6 Arizona is provided from the Transwestern pipeline, but El Paso has a monopoly on natural gas
7 service in central and southern Arizona, including the Phoenix and Tucson metropolitan areas.

8 7. Natural gas service in Arizona has experienced a great deal of uncertainty and has
9 changed in many ways in recent years. Natural gas demand has grown significantly in Arizona
10 and the Southwest, particularly in the electric generation sector. At the same time traditional
11 Arizona shippers, including APS and other utilities regulated by the Commission, have
12 experienced the loss of full requirements rights and other related circumstances which have raised
13 serious concerns about the ability of Arizona to have continued reliable natural gas service (and by
14 proxy electricity service) in the future.

15 8. Additionally, the net effect of the full requirements conversion and other Federal
16 Energy Regulatory Commission ("FERC") actions has been a significant shift of Arizona natural
17 gas sourcing from the San Juan supply basin to the higher cost Permian basin.

18 9. The Staff Report discusses a number of specific concerns that exist with regard to
19 Arizona's natural gas supplies, including: reduced access to San Juan gas, questionable firmness
20 and accessibility of some El Paso capacity serving Arizona, reduced operational flexibility at
21 higher cost, the failure of natural gas infrastructure in the Southwest to grow in proportion to
22 natural gas demand, the California settlement with El Paso regarding market manipulation
23 allegations, current and future El Paso pipeline proceedings, the current concentration of Arizona
24 regulatory risk at FERC on natural gas matters, uncertainty regarding future regional natural gas
25 market dynamics, and the national concern over natural gas supplies and prices.

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1 10. In response to the serious issues facing Arizona's natural gas service both now and
2 in the future, the Commission initiated the NOI in April 2003. Through the NOI, the Commission
3 has conducted several workshops and has received a good deal of input at a number of points in
4 the process from a variety of interested parties.

5 11. On December 18, 2003, the Commission issued its Policy Statement Regarding
6 New Natural Gas Pipeline and Storage Costs. This policy statement addressed a number of issues
7 including supply/infrastructure diversity, supply/infrastructure planning, the Commission's
8 approach to new infrastructure projects, the general Commission approach, individual utility
9 circumstances, and reporting. The policy statement also indicated that the traditional method of
10 utilities participating in infrastructure projects and then later having the Commission review such
11 participation is the preferred method, but given Arizona's natural gas infrastructure circumstances,
12 the Commission would consider applications for alternate cost recovery treatment, including pre-
13 approval.

14 12. APS' filing addresses many of the topics which the Commission's December 18,
15 2003, Policy Statement Regarding New Natural Gas Pipeline and Storage Costs identifies.

16 13. APS' filing requests pre-approval of the specific reservation charges, volumetric
17 charges, fuel charges, and applicable surcharges related to the specific block of pipeline capacity it
18 plans to acquire on the Silver Canyon pipeline project.

19 14. APS currently has a rate proceeding before the Commission (Docket Number E-
20 01345A-03-0437). Under consideration in the rate proceeding are issues such as whether APS
21 should have some form of power supply adjustor ("PSA") and whether the Pinnacle West Energy
22 Corporation natural gas-fired assets should be acquired by APS. Rather than try to address
23 possible outcomes of the rate proceeding, APS could make a filing after the rate case to address
24 issues in this pre-approval proceeding which are impacted by actions taken in the rate proceeding.

25 15. On September 29, 2003, APS entered into a precedent agreement with Silver
26 Canyon for pipeline capacity. The currently projected timeline for the Silver Canyon project is
27 that it would file with FERC in the fourth quarter of 2004, begin construction in the fourth quarter
28 of 2005, and begin service in the third quarter of 2006.

1 16. The precedent agreement contains a variety of termination rights which the parties
2 can exercise at various points in the process. Under the precedent agreement, Silver Canyon
3 would provide APS with certain operational flexibilities which enhance the value of the pipeline
4 capacity to APS.

5 17. In a situation such as the Southwestern natural gas market, where there is
6 uncertainty about so many issues, it is difficult to assess with certainty the relative benefits of one
7 pipeline project, such as the Silver Canyon project, with other new pipeline projects or existing
8 service options such as El Paso service, particularly as some benefits are difficult if not impossible
9 to quantify.

10 18. In comparison to service on El Paso, it appears that Silver Canyon service may be
11 somewhat more expensive, based solely on comparing Silver Canyon rates with existing El Paso
12 rates. However, with the likelihood of higher rates on the El Paso system, along with the access to
13 San Juan gas Silver Canyon provides, as well as the greater operational flexibility on the Silver
14 Canyon pipeline, it is possible that the Silver Canyon line may prove to be as economical, if not
15 more so, than El Paso service.

16 19. Additionally, introduction of a second pipeline into a region where one pipeline has
17 had a monopolistic position is likely to create a more competitive marketplace for pipeline service,
18 which should be beneficial to Arizona in the long term.

19 20. APS has estimated that acquisition of the Silver Canyon pipeline capacity would
20 increase its overall cost of natural gas 2.4 percent in 2007, to \$323 million and 0.6 percent in 2015,
21 to \$543 million.

22 21. The estimated impact of the cost of Silver Canyon capacity on a typical residential
23 customer bill is small. Further, in light of high natural gas commodity costs, the cost of pipeline
24 capacity has become less important in the overall cost of gas and the possibility of new natural gas
25 infrastructure enabling APS or other utilities to reduce their natural gas commodity costs has
26 become more important.

27 22. It appears likely that a good deal of uncertainty will continue to exist regarding
28 natural gas supply issues in Arizona and the Southwest, given current circumstances in the region.

1 However, there is little doubt that given the burgeoning natural gas demand in Arizona and
2 elsewhere in the Southwest that additional natural gas infrastructure will be needed to ensure
3 continued reliable natural gas service.

4 23. While the Commission traditionally has not pre-approved recovery of costs related
5 to the acquisition of pipeline capacity, the present, serious conditions existing in regard to
6 Arizona's natural gas infrastructure argue for action beyond the normal course of business at the
7 Commission, in this case.

8 24. APS' acquisition of Silver Canyon capacity can play a role in moving toward a
9 more robust natural gas infrastructure in Arizona and reducing the possibility of natural gas and
10 electricity service disruptions in the future. Further, APS' acquisition of Silver Canyon capacity
11 will likely only have a minimal upward impact on APS' customer bills and could under certain
12 circumstances actually reduce the overall cost of gas.

13 25. The Staff Report contains the following conditions:

- 14 • The Commission retains full authority to review APS' gas procurement activities, including
15 its management of all pipeline capacity and related activities, recognizing that the
16 Commission is pre-approving the underlying acquisition of the Silver Canyon capacity
17 during the initial ten year term of the agreement with Silver Canyon. The pre-approval
18 being granted in this proceeding would expire upon completion of the initial 10 year term.
- 19 • The impact, if any, on APS' risk profile resulting from pre-approval of costs related to
20 Silver Canyon pipeline capacity would be considered within the context of future APS rate
21 proceedings.
- 22 • APS shall file a status report on the Silver Canyon project and APS' participation in the
23 project with the Commission every six months until either APS begins taking service from
24 Silver Canyon or APS' participation in the project is terminated.
- 25 • APS shall notify the Commission when the exact volumetric and fuel rates are set for the
26 Silver Canyon pipeline, within ten days of such rates being set.
- 27 • APS shall notify the Commission within ten days of when the Company knows with
28 certainty that it will participate in the pipeline capacity volumes identified in the
application.
- APS shall notify the Commission within ten days of each of the following events regarding
the Silver Canyon project: Silver Canyon filing with FERC for approval of the pipeline,

1 FERC granting approval of the pipeline, Silver Canyon beginning construction of the
2 pipeline, Silver Canyon completing construction of the pipeline, and APS beginning to take
3 service from the Silver Canyon pipeline.

- 4 • APS shall notify to the Commission if at any time either APS or Silver Canyon exercise
5 termination rights pursuant to the precedent agreement or any other events significantly
6 impact APS' participation in the Silver Canyon project, within ten days of any such action.
- 7 • Pre-approval of the specific costs related to APS' acquisition of capacity on the Silver
8 Canyon pipeline is granted based upon the specific and unique conditions considered in
9 this application and will in no way commit or predispose the Commission regarding any
10 future considerations of pre-approval of costs. Rather, the standing presumption would be
11 that the Commission would not grant pre-approval in future proceedings, absent a careful
12 consideration of unique, serious, and important circumstances which would require such
13 action.
- 14 • None of the pre-approved costs will be passed on to APS ratepayers until all of the
15 following occur:
 - 16 ○ The Silver Canyon pipeline is built and operational.
 - 17 ○ APS is receiving service on the Silver Canyon project consistent with the precedent
18 agreement and this order.
 - 19 ○ APS' filing in compliance with the next condition is approved by the Commission
- 20 • APS shall meet with Staff and RUCO within 60 days of the final order being issued in the
21 current APS general rate proceeding to identify any issues in this proceeding that may be
22 impacted by actions taken in the rate proceeding and shall submit a compliance filing with
23 the Commission within 120 days after the final order addressing any such issues identified.
24 Such issues may include, but are not limited to, the cost recovery mechanism for Silver
25 Canyon pipeline capacity costs (net of savings) and the reporting requirements related to
26 Silver Canyon pipeline capacity.

26 26. Staff, APS, and RUCO have met a number of times to discuss this matter. It is
27 Staff's understanding that both RUCO and APS generally support the Staff Report and the
28 accompanying proposed order, based on discussions with those parties. Staff has sent an e-mail to
all parties on the e-mail distribution list for the Commission's Notice of Inquiry on Natural Gas
Infrastructure, indicating that APS has made the filing in this proceeding. Staff has placed the
APS application on the Commission's website to facilitate public access and contemplates placing
further documents related to this proceeding on the Commission's website. Staff will also notify
parties on the NOI e-mail distribution list as matters develop further in this proceeding.

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