

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION STAFF'S
NOTICE OF INQUIRY

ON THE ISSUE OF:

ARIZONA CORPORATION COMMISSION POLICY AND ACTION ON NATURAL GAS
INFRASTRUCTURE MATTERS IN ARIZONA

April 15, 2003

INTRODUCTION: This notice stems from a variety of factors which have greatly increased the importance of natural gas infrastructure matters in Arizona. Virtually all of Arizona's natural gas needs have traditionally been supplied under full requirements contracts on the El Paso Natural Gas Company (El Paso) interstate pipeline system. Under full requirements rights, shippers were allowed to utilize pipeline capacity on the El Paso system to meet their full needs. Service rights and reliability on the El Paso system have been a subject of controversy in recent years. On May 30, 2002, the Federal Energy Regulatory Commission issued an order requiring the conversion of full requirements contracts to limited contract demand contracts. While this conversion has not taken place to date, it appears likely that it will take place in the near future. Such a change in contract rights raises a variety of natural gas infrastructure related questions for Arizona, including what the cost, availability, and reliability of natural gas pipeline service will be in Arizona. Other developments which highlight the need for the Commission to evaluate its approach to natural gas infrastructure include higher and more volatile natural gas prices and the development of significant new natural gas demand in Arizona, particularly in regard to new electricity generation facilities. Currently there are no natural gas storage facilities in Arizona and El Paso is the monopoly interstate pipeline company for most of Arizona. However, there are three natural gas storage projects which have been proposed in Arizona, as well as a number of new interstate pipeline projects which would provide service to Arizona. To the extent such projects are constructed, they are likely to change the landscape of natural gas supply options for Arizona shippers.

PURPOSE: The purpose of this Notice of Inquiry ("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.

REQUEST: The Staff of the Commission requests that you answer the following questions and return your response either by email to bgray@cc.state.az.us or by mail to Robert G. Gray, Arizona Corporation Commission, 1200 West Washington, Phoenix, Arizona, 85007. Responses must be received on or before May 30, 2003. If you have further questions, please contact Bob Gray at 602-542-0827.

QUESTIONS: (Please feel free to attach additional comments)

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

SRP recommends that the ACC encourage the utilities, merchant generators and other interested parties to form a consortium, similar to the electric transmission group known as CATS (Central Arizona Transmission Study), to identify and study possible infrastructure needs and optimal site locations to ensure the needs of all Arizona users are met in the most efficient and cost effective manner, while maximizing supply reliability. At the conclusion of the process, the Commission may want to establish informal guidelines that incorporate the findings of the study group and encourage the development of additional natural gas infrastructure, such as natural gas storage and alternative sources of supply and pipelines in Arizona.

- 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.**

Natural gas storage can serve different functions for electric utilities (EUs) and local distribution companies (LDCs). Both can use it as a tool to dampen price volatility and as a way to meet peak requirements. However, LDCs usually do not need the rapid turn capability of salt cavern storage as much as the EUs. Therefore, the daily cycling costs to EUs will be substantially higher than those to the LDCs who tend to inject and withdraw on a more seasonal basis. Any policies established by the ACC will need to reflect these differences in the basic use of storage resources.

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

The ACC may want to address such issues as project funding and cost recovery, minimum requirements for storage, and acceptable alternatives to using storage (e.g., options for emergency/operational requirements). A CATS-like study process will allow for the exploration of other issues as they are identified.

- 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?**

The Commission should allow for the recovery of all prudently incurred costs associated with natural gas storage.

One cost category to consider is the recovery of additional transportation costs, in the form of additional variable costs and shrinkage. Another is an avoidance of costs, such as using storage to avoid peaking transportation services.

Storage-related costs would best be recovered through a fuel or purchased gas adjustment mechanism.

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.**

The primary responsibility of the ACC should be to ensure natural gas supply reliability. Natural gas storage is just one tool in a portfolio that utilities can use to ensure reliability of supply. Another benefit of using gas storage is to reduce price volatility. With the pending conversion of full requirements contracts to contract demand status, it is even more critical that utilities consider storage and other options.

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?**

As suggested in our response to Q. 1, SRP recommends that the ACC encourage the utilities, merchant generators and others to form a consortium, with the purpose of identifying and studying possible infrastructure needs and site locations to ensure the needs of all Arizona users are met in the most efficient and economical manner. Through this statewide collaborative effort, the ACC can be assured that the group's participants will consider only projects that address the dual goal of maximizing customer benefits while minimizing cost.

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?**

While gas storage, long-term supply contracts and financial hedging are all methods used by utilities to reduce price volatility, natural gas storage has the added benefit of providing the utility with a ready supply of gas, particularly during times when peak demand exceeds pipeline delivery. These portfolio tools can be used in the utility's overall strategy to minimize price and price volatility while optimizing its supply portfolio and increasing reliability.

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?**

Well-designed and located storage can replace peaking transportation requirements. However, the definition of "well designed and located" will vary for each utility. The utility's long-term plan should balance reliability and storage needs in order to optimize supply options in the most cost effective manner possible.

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

The ACC may want to encourage each utility to pre-establish a level of minimum operational reserves based on the utility's long-term plan.

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?**

The ACC should generally support new interstate pipelines in Arizona. Developing a more specific ACC policy on the use of interstate pipelines is inappropriate, as each utility's needs must be viewed on an individual basis, since each utility has different requirements and underlying assets. As noted in our response to Q. 1, SRP recommends that the ACC encourage the utilities, merchant generators and other interested parties to form a consortium to identify and study possible infrastructure needs and site locations. By forming such a collaborative effort, the ACC can ensure the needs of all Arizona users are met in the most efficient and cost effective manner.

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 ACC should encourage additional pipeline and storage projects in Arizona. As suggested in our response to earlier questions, through a consortium, the ACC will be able to determine the best way for additional infrastructure to be developed at the state level. The ACC's active participation in gas supply issues before FERC, including individual projects planned for Arizona, will also be helpful in bringing new infrastructure 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?**

The ACC should address how the use of interstate pipeline facilities fit into each utility's supply portfolio on a utility-specific basis, recognizing that each utility has different requirements and existing assets. Thus, the balancing of each of the above-listed goals should vary by each utility's circumstances.

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?**

In general, the ACC should encourage utilities to diversify their sources of interstate pipeline capacity as supply diversity will allow for greater reliability and less supply interruptions. As previously discussed however, the ACC should determine how interstate pipeline facilities fit into each utility's supply portfolio on a utility-specific basis.

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

There are none that come to mind. Addressing the issues associated with natural gas storage and new pipelines is key.

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?**

As discussed previously, the ACC should encourage the utilities, merchant generators and other interested parties to form a consortium to identify and study possible infrastructure needs for Arizona users. As the approval of these types of potential facilities fall within the jurisdiction of the FERC, the ACC should also

actively participate in FERC proceedings that could impact Arizona's future gas infrastructure.

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

The ACC may also find it useful to discuss possible innovative contract structures, such as a situation where an LDC and an EU co-own capacity to minimize the level of investment necessary to meet each one's peak requirements.

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

Yes. SRP would also encourage the ACC to form a consortium of interested parties, similar to the electric transmission group known as CATS (Central Arizona Transmission Study), to identify and study possible infrastructure needs and optimal site locations to ensure the needs of all Arizona users are met in the most efficient and cost effective manner.