0000054143

30

MEMORANDUM

TO: Docket Control Center

FROM: Ernest G. Johnson
Director
Utilities Division

Date: May 16, 2006

RE: STAFF REPORT ON SOUTHWEST GAS CORPORATION FILING FOR PRE-APPROVAL OF COST RECOVERY FOR PARTICIPATION IN THE TRANSWESTERN PIPELINE PHOENIX LATERAL PROJECT (DOCKET NO. G-~~1551~~ 0155 1A-06-0107)

Attached is the Staff Report for the above referenced matter.

EGJ:BGG:lhm

Originator: Robert G. Gray

RECEIVED
2006 MAY 16 P 3: 29
AZ CORP COMMISSION
DOCUMENT CONTROL

Staff Report on Southwest Gas Corporation Filing for Pre-Approval of Cost Recovery for Participation in the Transwestern Pipeline Phoenix Lateral Project

May 16, 2006

REDACTED VERSION

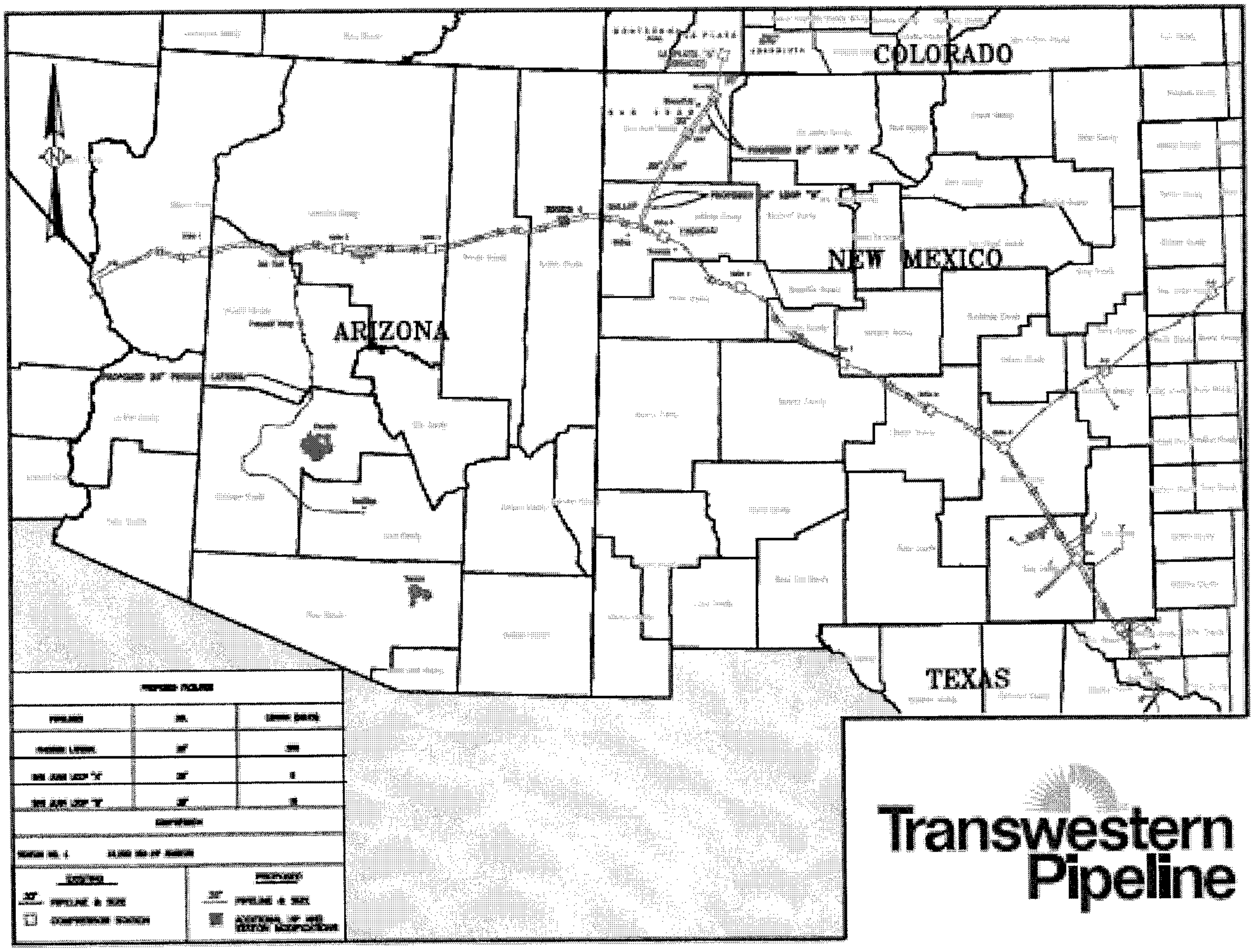
Docket No. G-01551A-06-0107

Table of Contents

Introduction

On February 23, 2006, Southwest Gas Corporation ("Southwest" or "Company") filed for Commission pre-approval of cost recovery for participation in the Transwestern Pipeline Phoenix natural gas pipeline project ("Phoenix Project"). The Phoenix Project is a proposed new project which Transwestern Pipeline ("Transwestern") would build from the San Juan supply basin in northwest New Mexico to the Phoenix metro area. Southwest' filing is pursuant to the Commission's on-going Notice of Inquiry on Natural Gas Infrastructure, which the Commission initiated in April, 2003, to consider issues related to natural gas infrastructure and their impact on natural gas service in Arizona. Southwest' application is the second request for pre-approval related to the Phoenix Project. Previously the Commission approved an application by Arizona Public Service Company for the pre-approval of certain costs related to pipeline capacity on the Phoenix Project (Decision No. 68597, March 23, 2006), subject to certain conditions. Southwest has provided Staff with certain confidential information related to its application. This Staff Report represents Staff's evaluation and recommendations regarding this Southwest filing. Separate unredacted and redacted versions of this Staff Report were prepared.

Staff recommends that the Commission approve the Southwest filing, subject to a number of conditions.



Source: Transwestern

Description of Phoenix Lateral Pipeline Project

The proposed Phoenix Project would run from the San Juan supply basin in northwest New Mexico to central Arizona, providing shippers with additional access to San Juan basin natural gas and indirect access to additional Rockies supplies. The first segment of the project entails a 375,000 dth/day expansion of Transwestern's existing pipeline system running out of the San Juan basin along with some utilization of unsubscribed capacity on the San Juan laterals. The second segment of the project will utilize unsubscribed capacity on Transwestern's existing mainline which runs across northern Arizona. The third segment will begin west of Flagstaff, running south through Yavapai County, skirting the Phoenix metro area to the west, and ending near Coolidge, Arizona. The Phoenix Project would have some ability to add additional capacity in the future if such growth is warranted. Projected dates in the progress of the project include Transwestern making a filing with Federal Energy Regulatory Commission ("FERC") by August 2006, beginning construction in August 2007, and commencing operation in April 2008. Transwestern is actively moving forward with the Phoenix Project, being currently involved in the National Environmental Policy Act ("NEPA") process at FERC, having held a number of meetings in communities near possible pipeline routes, and taking other actions.

Siting of the proposed Phoenix Project is not at issue in this proceeding, as FERC has primary siting authority for natural gas interstate pipelines. This proceeding addresses cost recovery by Southwest of costs related to the Phoenix Project pipeline capacity.

Background

The continued high cost of natural gas in recent years has impacted all consumers of natural gas, whether they are local distribution companies ("LDCs") such as Southwest, or other natural gas consumers such as electric generators or industrial customers. While Southwest has seen some growth in total natural gas throughput in recent years, as a percentage of natural gas consumption in Arizona, LDC consumption has shrunk considerably, as electric generation has become by far the largest consumer of natural gas in Arizona. Southwest experiences its peak natural gas consumption during the winter heating months, in contrast to natural gas demand for electric generation, which peaks in the summer months.

Southwest's service territory covers a significant portion of Arizona, including Tucson, most of the Phoenix metro area, and a number of rural areas. As a result, Southwest takes service from El Paso via a large number of taps on the El Paso pipeline system, many of which are relatively small. This contrasts with electric generation entities in Arizona, which take service from El Paso at a small number of power plant locations.

Due to Southwest's dispersed consumption of natural gas across many locations, it approaches a new interstate pipeline such as the Phoenix Project differently than electric generators. For an electric generator, the large amount of natural gas consumption at a single location provides economies of scale that enable it to more easily construct facilities and take other actions to acquire service from an alternate pipeline.

According to the recently completed "Arizona Natural Gas Market and Infrastructure Study" by Energy and Environmental Analysis, Arizona is served by El Paso's northern pipeline system with a capacity of 2.2 billion cubic feet (bcf)/day, El Paso's southern system with a capacity of 2.5 bcf/day, Transwestern's northern Arizona pipeline with a capacity of 1.2 bcf/day, and Questar's Southern Trails pipeline in northern Arizona with a capacity of 0.08 bcf/day. Most of Transwestern's capacity, and a large portion of El Paso's capacity, has traditionally served California, although California has in recent years reduced its reliance on these pipelines running through Arizona. Arizona shippers in northern Arizona have some ability to access supplies from different pipelines, but shippers in central and southern Arizona, including Southwest's consumption, are at this time totally reliant on service from El Paso to meet their needs. Until FERC action in recent years, many Arizona shippers were contractually bound to take all of their interstate pipeline service from El Paso.

Service on El Paso has undergone a great deal of change and uncertainty in recent years, and such change is likely to continue in the near future as FERC considers El Paso's current rate proceeding and other matters. Issues of debate in recent years on the El Paso system include the allocation of delivery rights at Topock, elimination of full requirements rights for large East-of-California ("EOC") shippers, California's pursuit of market manipulation allegations against El Paso and others, implementation of Order 637 provisions on El Paso's system, and a host of issues being addressed in the current El Paso rate proceeding at FERC. Such continued upheaval on El Paso's system has created a more difficult environment to operate in for all Southwestern natural gas market participants, including Southwest. A major contributor to upheaval in the Southwestern markets has been major shifts in utilization of El Paso's pipeline system by California shippers, exemplified by Pacific Gas and Electric's ("PG&E") turn back of capacity in the mid 1990's and Southern California Gas' ("SoCal") recently announced turnback of capacity. Such major shifts in pipeline utilization create difficult circumstances for both El Paso and for other shippers in the region. This unsettled situation has been further exacerbated by the recent discounted contracts El Paso has negotiated with California shippers, including PG&E and SoCal, which provide for discounted pipeline capacity charges for such shippers and exempt them from potential cost increases in the current El Paso rate proceeding. Additionally, the other shippers on El Paso's system, including Southwest, may have to bear some or all of the cost burden for large blocks of unsubscribed capacity formerly held by California shippers, as well as the revenues lost by El Paso due to the discounted contracts with California shippers.

A fundamental difference in the circumstances of California shippers and Arizona shippers is that California shippers have a diversity of supply options beyond El Paso, from instate production to the recently expanded Kern River pipeline accessing Rockies gas, to the Pacific Gas Transmission pipeline accessing Canadian gas, to the likely introduction of Liquefied Natural Gas ("LNG") supplies into the California market in the near future. Most Arizona shippers, including Southwest, do not currently have such supply options. It is no coincidence that Arizona shippers have not been offered capacity discounts by El Paso as California shippers have, but rather stand to likely pay for those California discounts. It would appear that one of FERC's charges is to protect captive shippers such as Arizona shippers from having to pay for the discounts given to more advantageously situated shippers such as SoCal and PG&E. Whether such protection will in fact be afforded to Arizona shippers in the current El Paso rate proceeding or in future FERC proceedings is yet to be determined.

One benefit of the introduction of interstate pipeline service into central Arizona by a competitive pipeline is that it will diversify the risk of adverse regulatory rulings at FERC for Arizona. Due to the dominant position of El Paso in Arizona currently, an adverse regulatory ruling in regard to El Paso's pipeline system can have an enormous impact on Arizona natural gas service. To the extent Arizona shippers take service from multiple pipeline companies, the potential impact of adverse regulatory rulings on any one pipeline system is lessened.

Realistically, Arizona will always be dependent to a significant degree on El Paso and its considerable lateral system for natural gas service in Arizona. However, construction of a competing pipeline into central and/or southern Arizona would provide at least a modicum of potential pipeline competition for El Paso and would make it more difficult for El Paso to look to captive Arizona customers to cover the costs of discounted contracts for California shippers.

Southwest's Circumstances in Light of Recent Developments on the El Paso Pipeline System

In looking at the Phoenix Project, Southwest either needs to be able to have the pipeline built to areas where it can directly take natural gas or it needs to be able to feed gas from the

Phoenix Project across El Paso's system at certain points, such as El Paso's lateral system in the Phoenix area. Southwest's application in essence takes the first approach, having worked with Transwestern to take service at certain locations where Southwest is seeing or will soon see growing demand for natural gas and can take direct service from Transwestern. For service to other, already built-up areas in and around Phoenix, it is generally not feasible due to cost and other constraints for a competing pipeline to build into areas currently served via El Paso's lateral system.

The difficulty for Southwest in pursuing the second option of sending gas across the El Paso system can be seen by a review of recent developments. With the rise of potential new pipeline developers in Arizona, El Paso has taken a number of actions which are construed by a number of entities as being anti-competitive and which erect barriers to the development of natural gas infrastructure in Arizona by other parties. El Paso, in its current rate proceeding before FERC, eliminated its short-haul rate in its initial filing and proposed to offer its new service offerings on a bundled basis. Despite protests from the Arizona Corporation Commission ("ACC") and other parties, FERC's July 29, 2005 order upheld El Paso's elimination of the short-haul rate in its initial filing. The short-haul rate was addressed again in FERC's March 23, 2006 order on technical conference issues, that stated:

> "there is no Commission policy that would require El Paso to provide a short-haul rate to its consumers. The Commission finds that El Paso's rates meet the requirement of being distance sensitive as they are differentiated by geographic zones. All issues relating to the elimination of the short-haul rate on market centers may be addressed by the hearing."

At the very least, this means that there is no short-haul rate in the short term, and casts doubt about the existence of a short-haul rate in the long term, let alone whether such a rate is priced reasonably. Absent a reasonably priced short-haul rate, a shipper wishing to route gas from a competing pipeline such as the Phoenix Project onto an El Paso lateral for final delivery to the shipper's delivery point would have to pay El Paso's full zonal tariffed rate for Arizona on top of the pipeline reservation rate for the competing pipeline. This would be the case even if the natural gas was only passing over a very short segment of El Paso's system. Such a rate structure would have little relationship to the cost of providing such short-haul service. The net effect is that no shipper is likely to be able to afford to route gas onto the El Paso system for delivery from another pipeline, in essence largely reinstating El Paso's monopoly for most pipeline service to customers served off of its pipeline system in Arizona. This turn of events significantly reduces Southwest's ability to seek service from a pipeline other than El Paso, given the dispersed nature of Southwest's load and its locations in developed areas served off of El Paso's lateral system. While the final resolution of the short-haul rate is unclear at this time, El Paso may well succeed in stifling competitive access to customers served off its lateral system in Arizona. To the extent FERC does not address competitive issues on the El Paso's pipeline system in El Paso's current rate proceeding, Southwest's ability to potentially access other pipelines or pipeline service providers will be significantly stifled.

Arizona's Competitive Position in the Southwestern Natural Gas Market

An important but difficult to quantify factor in evaluating a possible new market entrant such as the Transwestern project is what the value of having pipe-on-pipe competition is in a given market area. Many major markets in the United States have multiple pipelines servicing them and over time shippers have some level of flexibility to shift their pipeline service from one pipeline to another. Under the current approach to pipeline regulation at FERC, markets which have the ability to take service from multiple pipelines are at a significant advantage to those who have a single monopoly service provider, despite assurances that captive shippers will be afforded protections against the exercise of market power.

A prime example of such an advantage is the recent signing of discounted pipeline capacity contracts by El Paso with SoCal and PG&E. These contracts both provide these shippers with below tariffed rate discounts, and largely shield them from the negative impacts of El Paso's on-going rate proceeding at FERC. These California utilities have multiple pipeline options, enhanced by the recent Kern River Pipeline expansions and looming LNG imports. Therefore, they have some ability to take service from providers other than El Paso. In contrast, Arizona shippers have not received such discounted contracts from El Paso, likely because Arizona shippers in central and southern Arizona currently have no pipeline options, but rather must take all their service from El Paso. Further, it can be expected that the revenues lost by El Paso through the discounts to the California shippers will likely land on the shoulders of Arizona shippers who have no ability to avoid them. While such action by FERC is not certain, El Paso is unlikely to willingly swallow the revenue loss from California, but rather will look to recoup such revenues from other shippers, including the largely captive Arizona market. Arizona is always likely to be at some level of disadvantage to California in regards to natural gas supply diversity, but expansion of a competing pipeline in Arizona, along with other infrastructure developments and possible LNG import impacts stand to potentially enhance and diversify Arizona's natural gas infrastructure and supply options.

The ability of California shippers to receive discounts from El Paso and the lack of such discounts for Arizona shippers is a stark example of the impact of diversified pipeline options for shippers. Staff believes that the benefits of pipe-on-pipe competition would be far from inconsequential and should be an important factor in considering pre-approval of Arizona utilities acquisition of capacity on a potential new pipeline in Arizona. The opportunity to bring some level of pipe-on-pipe competition to the central Arizona market is significant and of long-term importance. The proposed Transwestern pipeline project represents such an opportunity to bring pipeline competition to central Arizona.

Another potential benefit of the Transwestern project is that it could eventually lead to the establishment of a new pricing point in central Arizona for natural gas spot market prices and other pricing instruments. Such market centers often form where multiple pipelines interconnect, possibly with gas storage in the area. A benefit of such a market center formation would be that Arizona entities would have the opportunity to buy and sell and hedge gas at a price that is more closely reflective of their local market conditions. If a natural gas storage facility is built in central Arizona, the Transwestern line could potentially interconnect with such a facility, providing further options for Southwest and other Arizona shippers to manage their natural gas supplies.

Impact on Arizona's Access to Natural Gas Supplies

The Phoenix Lateral project would increase Southwest's and Arizona's access to the San Juan supply basin in northwest New Mexico and indirectly to growing and prolific Rocky Mountain production areas in Colorado and Utah, north of the San Juan basin. One result of the end of full requirements service for Arizona shippers and the resulting pipeline capacity allocation is that Arizona shippers' access to the San Juan basin was noticeably reduced. On a contractual basis, Southwest's contract volumes are split with approximately 43 percent San Juan gas and 57 percent Permian gas. The addition of the Transwestern capacity would shift this balance for Southwest to emphasize San Juan capacity, but given the relatively small amount of capacity Southwest would acquire on the Phoenix Project, this does not represent a major shift in Southwest's sourcing of natural gas supplies. As discussed elsewhere, given that San Juan gas is typically cheaper, such a shift likely represents a savings to Southwest on its commodity costs.

Information provided to Staff by El Paso shows that Southwest's split of actual gas flowed is weighted much more heavily toward San Juan supplies than is seen on the split of contracted capacity. In 2005, the lowest percentage of San Juan gas receipts Southwest experienced was 53.52 percent on November 30, 2005 and the highest percentage was 100 percent on a number of days early in 2005. Generally speaking the percentage of San Juan receipts ranged from around 60 percent to well over 90 percent. This reflects Southwest generally using its San Juan capacity first and Permian capacity second, as would be expected given the traditional price advantage of San Juan gas. Addition of the Transwestern capacity would likely move these percentages up at least moderately, though additional overall demand growth would tend to move the percentage the opposite direction. Staff does not believe that addition of the Transwestern capacity in anyway causes Southwest to be overly committed to the San Juan basin, as Southwest holds very significant Permian basin capacity which it often does not need to use significantly to meet its actual demands, but which is available if needed.

Looking at a total physical delivery capability basis of the existing interstate pipeline infrastructure in the Southwest, there is currently much more physical pipeline delivery capability into central and southern Arizona from the Permian basin, via El Paso's southern system, than there is from the San Juan basin via the Maricopa lateral, the Havasu crossover, and El Paso's Line 1903 project. Addition of the Transwestern project to the Southwest's infrastructure would provide an additional avenue for San Juan gas to enter central and southern Arizona. Even with the addition of the Transwestern project, there would be more physical delivery capability from the Permian basin, but the balance of physical capacity from the two basins would be much closer, enhancing the diversity of possible supplies coming into central and southern Arizona.

Considerations Regarding El Paso's Current Rate Proceeding Before FERC

As has been the case for a number of years, there is currently a good deal of uncertainty regarding important service issues on the El Paso pipeline system. The current El Paso rate proceeding before FERC encompasses many of these uncertainties. El Paso has put forward a variety of proposals in the rate proceeding which, if adopted, will greatly change the operation of its pipeline in the Southwest and will both increase cost and reduce operational flexibility for Arizona shippers, including Southwest. Major issues in the rate proceeding (beyond typical rate case issues such as cost of service, etc.) include existence and structure of a short haul rate, the need for and design of a variety of potential new services El Paso has proposed, El Paso's proposal to shift from monthly balancing to daily and hourly balancing and associated penalty provisions, El Paso's proposals regarding delivery codes ("D-Codes") and related delivery issues, pressure guarantees, applicability of Section 11.2 provisions from the 1996 settlement agreement, restrictions on FT-2 service, and other issues. Some of these issues are currently under consideration by FERC in the technical conference phase of the rate case, while others will be considered in the upcoming hearing phase of the rate case.

FERC has held two technical conferences, and El Paso has held shipper meetings to discuss how El Paso's proposals would work and possible changes to such proposals. El Paso has made some changes to its proposals in response to shipper discussions, but many shippers have indicated a continued high level of concern regarding El Paso's proposals and also some level of continued difficulty in understanding how things would work under El Paso's proposals. The sheer complexity of the many proposals in total and how they would impact all the contracts and volumes shippers hold on the El Paso system creates both uncertainty and an expectation that it will be more difficult for a shipper to operate on the El Paso system. For example, hourly and daily balancing within tight operating bounds could make it challenging for Southwest to avoid penalties while adjusting to changing natural gas demand due to weather and other factors on its system. Some of these issues reflect larger national discussions taking place at the North American Energy Standards Board ("NAESB") and in other forums. It is possible that an end result of El Paso's rate proceeding could be that Southwest will be forced to seek additional pipeline capacity to maintain its current quality and quantity of service from El Paso.

The continued uncertainty regarding service on the El Paso system contrasts with the opportunity to largely define specific costs and operating conditions on the Transwestern system for the 15-year length of Southwest's contract with Transwestern. For example, Southwest can lock in a fixed reservation rate for the 15-year period with Transwestern, while on El Paso it is far from clear what will happen to El Paso's reservation rate for Southwest over the next 15-year period. Regarding balancing, Transwestern would allow Southwest to balance monthly with a 10 percent tolerance.

On March 23, 2006, FERC issued an order regarding the technical conference issues in El Paso's rate case. The order broadly adopts El Paso's proposals, though it rejected daily balancing in non-critical conditions and required an expansion of the hourly balancing tolerances. There is some uncertainty regarding interpretation of certain details in the March 23, 2006 FERC order and a wide variety of parties, including the ACC, El Paso, and a large number of shippers have requested rehearing on a wide variety of issues, including balancing provisions, so it is still unclear what the end result will be regarding El Paso's new service proposals, balancing provisions, and other technical conference issues. The procedural schedule for the hearing phase of the El Paso rate proceeding contemplates the issuance of an initial decision in August of 2007. Additionally, El Paso has entered into settlement discussions with FERC Trial Staff and parties to the case. Some service issues may be addressed in some fashion as part of this settlement process.

At this time it appears likely that operating conditions on El Paso's system over the next 15 years will likely not provide the same level of flexibility as the Transwestern project would provide Southwest. Greater certainty may develop on El Paso's system in the future, but then again, El Paso's system has often seen much contention for many years and it is never clear when California shippers may take further action to upset El Paso's system with another capacity turnback or other action. Because the Transwestern Phoenix lateral does not continue on to California, it would seem to be less subject to actions taken by California parties.

In the on-going El Paso rate case before FERC, various parties, including the ACC, Southwest, and Transwestern, have raised concerns regarding certain actions by El Paso in the proceeding that may have anti-competitive impacts in Arizona. Issues include El Paso's elimination of its short-haul rate, the bundled nature of the proposed new services El Paso has proposed, and El Paso's elimination of its backhaul service. These matters remain to be resolved by FERC, though the March 23rd order adopted El Paso's proposals to bundle services and eliminate backhaul service. Uncertainty regarding how and when these issues will be resolved by FERC has created a more difficult environment in Arizona for infrastructure developers other than El Paso. As noted elsewhere, El Paso's elimination of the short-haul rate in Arizona and failure to offer a reasonably priced alternative makes it very difficult for gas flowing on any pipeline other than El Paso's to be reliably delivered to the many end-users fed through El Paso's extensive Phoenix lateral system as well as customers served through other laterals in Arizona.

Pipeline Service Reliability

Regarding reliability of pipeline service, Staff does not believe there are any major disparities in pipeline service reliability between service from the proposed Phoenix lateral in comparison to service from El Paso. Transwestern's proposed project would use multiple pipes from the San Juan basin to the Ashfork area and would use a single line from Ashfork into central Arizona. While a single line does not provide redundancy in and of itself, it will be a newly constructed line and is expected to be highly reliable for many years. By comparison, El Paso's pipeline system is relatively old and therefore would be expected to require more maintenance and have a slightly higher potential for an outage. But this is counterbalanced by the extensive nature of El Paso's pipeline system, with multiple pipes in both its north and south system, enabling El Paso to use other assets to meet its service commitments. In summary, Staff does not believe that reliability of one service option in comparison to another is a major factor in considering whether Southwest's application for pre-approval should be approved. However, another pipeline such as the Phoenix Project, feeding into central Arizona would enhance and diversify the overall natural gas infrastructure in central Arizona.

Description of the Phoenix Project Expansion Agreement Between Southwest and Transwestern

The Phoenix Project expansion agreement was entered into by Southwest and Transwestern on February 14, 2006. Southwest has provided Staff with an unredacted version of the expansion agreement. Attachments to the agreement contain details regarding the maximum daily transportation quantity for receipt and delivery points and related details for each month of the term of the agreement. The receipt point is the Blanco hub in the San Juan basin, a major trading hub in that basin. The delivery points are in a number of areas where Southwest anticipates additional growth in demand for natural gas in its service territory. [redacted]

Month	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		Total dth/day	
January	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
February	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
March	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
April	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
May	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
June	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
July	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
August	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
September	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
October	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
November	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	
December	[redacted]		[redacted]		[redacted]		[redacted]		[redacted]		[redacted]	

Annual average: [redacted] dth/day

The specific cost components Southwest is seeking pre-approval of recovery for are the reservation charge, volumetric variable usage rate, miscellaneous surcharges, and fuel and lost and unaccounted for gas. For the reservation rate, the agreement contains a number of options Southwest may choose as it sees fit in determining what its reservation rate will be on

Transwestern. The first option is to pay a fixed $[redacted] per dth rate for receipt on the San Juan lateral for the 15-year term of the contract. This appears to be the most likely option for Southwest at this time, as it provides for access to lower priced San Juan gas. A second option is Southwest could choose to pay a fixed $[redacted] per dth rate for receipt on the portion of Transwestern's pipeline which is East-of-Thoreau. This would in effect enable Southwest to switch its receipts from the San Juan basin to an area further east such as the Permian basin if Southwest so wished. Further, at the time the Phoenix project would go into service, Southwest could opt to take service at the reservation rate established by FERC as it varies over time. Or at the in-service date Southwest could take service at a negotiated rate that would be fixed at the initial reservation rate established by FERC. Southwest can choose between these various rate options at the time it initiates service with Transwestern.

[redacted]

The precedent agreement contains a variety of termination rights for both Southwest and Transwestern if either party fails to take certain actions or meet certain criteria. Of note, one provision enables Southwest to terminate the precedent agreement if "the Arizona Corporation Commission has not issued an order on or prior to [redacted], authorizing the recovery by Shipper for ratemaking purposes of the costs to be incurred by Shipper under the Transportation Agreement." Subsequently, Southwest and Transwestern negotiated a one month extension of the pre-approval date, to the end of [redacted]. Staff believes that the [redacted] deadline does not create any timing difficulties for processing Southwest's application.

Southwest Gas Pipeline Capacity

Southwest's monthly sculpted pipeline capacity on the El Paso system is shown below for each month in 2006.

Month	January 2006	February 2006	March 2006	April 2006	May 2006	June 2006
Volume (dth)	737,961	649,056	592,857	439,490	420,184	348,522
Month	July 2006	August 2006	September 2006	October 2006	November 2006	December 2006
Volume (dth)	339,379	339,389	354,108	372,741	528,263	694,959

Southwest's projected peak day demands are reflected in the following table.

Heating Season	Projected Peak Day Delivery (dth)
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

Southwest's projections reflect a level of growth that appears to reflect that Southwest should be able to utilize the additional Transwestern capacity, in addition to its existing capacity on the El Paso system, to meet the new incremental growth. Any period of time in which Southwest would not be fully utilizing the Transwestern capacity would likely be relatively short in duration and Southwest could likely minimize any excess capacity it would have during that short period of time through capacity release and other avenues.

Since the conversion of full requirements customers to contract demand customers in September 2003, Southwest and other East-of-California shippers have not signed new contracts reflecting the conversion, due to a number of factors, including disagreement with El Paso on various contract terms. It is unclear what terms and conditions will be contained in a new contract between Southwest and El Paso.

Cost Analysis of Transwestern Service to Southwest

Southwest's application contains a net present value cost analysis, comparing the total impact on Southwest's gas supply portfolio if service is taken from El Paso only or if service is taken from both Transwestern and El Paso from 2006 through 2018. Southwest presents four scenarios, reflecting possible changes in existence of a basin price differential, duration of a basin price differential, and availability of seasonal capacity on the El Paso system to meet incremental growth for Southwest. Southwest's base case reflects a basin differential of $0.30 per dth, the basin differential lasting for six of the projected 12 year period, and availability of seasonal capacity on El Paso to meet growth. Each of the three other scenarios varies one of these criteria. Southwest's second scenario reflects Southwest's estimated costs if seasonal capacity was not available on the El Paso system to meet incremental growth. Southwest's third scenario reflects a change in that the basin differential of $0.30 per dth lasts through the full 12 year period. Southwest's fourth scenario reflects a lack of any basin differential during the 12 year period.

A significant factor in Southwest's modeling of its total costs in taking service from El Paso or from El Paso and Transwestern is the impact on the need for Southwest to undertake capital projects in the coming years. For example, Southwest plans to take service from Transwestern [redacted] This area is one of the areas where Southwest anticipates significant growth in the Phoenix metropolitan area, and currently there are no major natural gas lines in the area to serve this new growth. [redacted] Southwest would have to construct significant lateral facilities to extend service into this area. However, with the Transwestern pipeline running through the area, Southwest will largely avoid such expenditures, needing only to build infrastructure locally to take service off of the nearby Transwestern pipeline that would be passing through the area already. Such capital savings play a significant role in Southwest's overall costs of taking service from Transwestern in comparison to El Paso.

Staff met with Southwest employees to review Southwest's modeling of the costs under the four different scenarios and Staff believes that for purposes of reviewing this pre-approval application, Southwest's cost estimates appear reasonable given the significant uncertainty surrounding future natural gas service issues on interstate pipelines in the Southwest. The table below shows the results of Southwest's four scenarios of the net present value from 2006 to 2018.

Scenario	Total Cost of TW and El Paso Service ($1,000s)	Total Cost of El Paso Service Only ($1,000s)	Difference ($1,000s)	Basin Differential	Period of Differential	El Paso Seasonal Capacity Available?
1 – base case	$4,438,536	$4,436,240	$2,296	$0.30 per dth	6 years	Yes
2	$4,458,933	$4,487,433	($28,500)	$0.30 per dth	6 years	No
3	$4,445,123	$4,446,834	($1,711)	$0.30 per dth	12 years	Yes
4	$4,431,834	$4,427,713	$4,121	None	None	Yes

A review of these scenarios shows that in some cases adding Transwestern could increase Southwest's costs, while in other cases adding Transwestern could decrease Southwest's costs. By far the greatest impact of the factors which are varied is whether El Paso seasonal capacity is available to Southwest. Without El Paso's seasonal capacity being available, Southwest's costs are much less when Transwestern is included in Southwest's gas supply portfolio. This reflects the situation that Southwest currently holds more capacity on the El Paso system than it needs through the summer months as a result of the capacity allocation process in 2003. So if Southwest had to buy an even 12 month block of capacity, it would have little use for that additional capacity during the summer months. Therefore, whether through Transwestern's sculpting of capacity for Southwest, or by other means of taking seasonal service to meet Southwest's need for additional winter capacity in the coming years, such seasonal capacity is an important factor for Southwest.

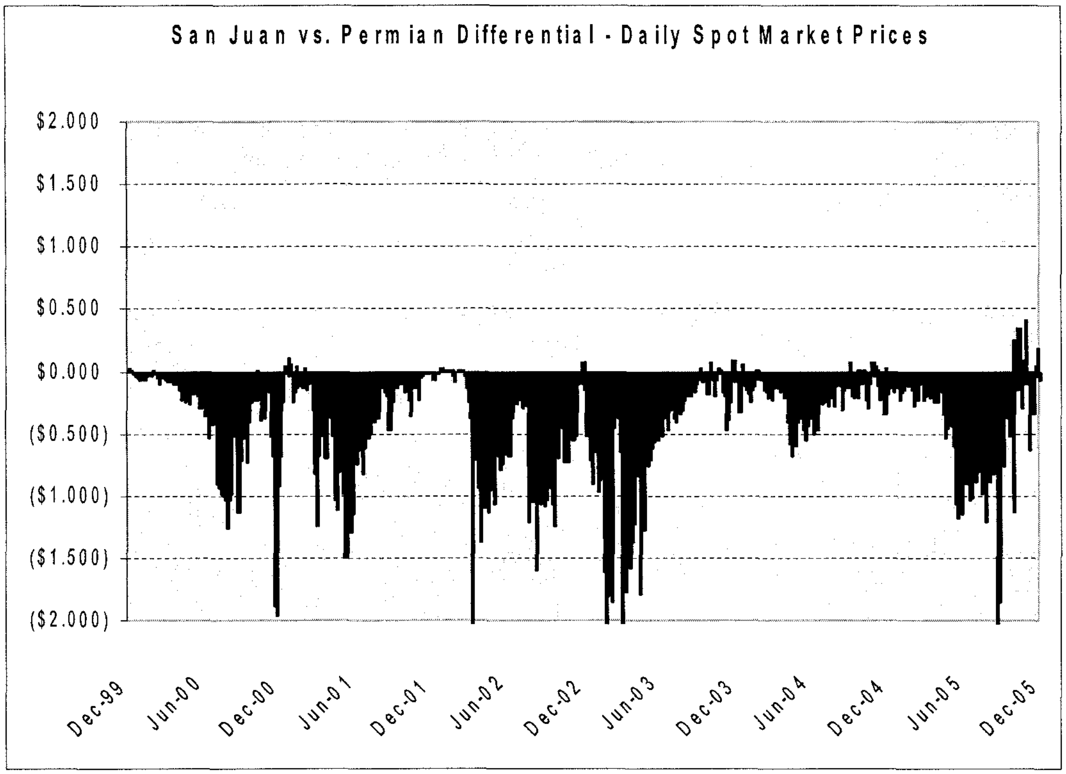
Looking at a single year, Southwest estimates its reservation charges on Transwestern to cost approximately $[redacted] million. By comparison, Southwest estimates its entire cost for gas supplies and pipeline capacity in 2007 will be approximately $500 million. Thus, any incremental cost impact of Southwest's acquisition of capacity from Transwestern is likely to be very small in comparison to its overall on-going natural gas costs. This reflects both the relatively small volume of capacity Southwest is acquiring from Transwestern as well as the relatively comparable costs of taking service from Transwestern or El Paso over the time period contained in Southwest's analysis.

Regarding the price differential between San Juan and Permian gas supplies, Southwest's use of a $0.30 per dth differential is generally reflective of the average daily spot market price differential in recent years. San Juan gas has been less expensive than Permian gas most of the time for quite a number of years, but the differential has fluctuated based upon a variety of market conditions. The average difference in daily spot market prices between the San Juan and Permian basins in recent years is shown in the table below:

Year	2000	2001	2002	2003	2004	2005
Differential $/dth	$0.315	$0.329	$0.416	$0.510	$0.165	$0.356

Source: Gas Daily

The chart below shows the daily spot market price differential ($/dth) between the El Paso – Permian Basin and El Paso – San Juan Basin pricing points in recent years. While the future difference in prices between the two basins is unknown, San Juan gas appears to be remaining the lower priced natural gas option most of the time. Negative numbers indicate that San Juan gas is cheaper than Permian gas.



Source: Gas Daily

It is true that when new pipelines are built into a supply area, there may be some reduction in the differential between that supply area and other supply areas, as the new pipeline creates an additional outlet for natural gas supplies from the given supply area. Thus, the very construction of the Transwestern project may result in some additional competition to purchase San Juan gas, possibly impacting the basin differential between San Juan and Permian gas. A variety of other factors may impact the relative price of natural gas in supply basins in the Southwest. However, other expansions into the San Juan basin have been undertaken in the past, and the San Juan basin has continued to generally exhibit lower prices than the Permian basin. Southwest's use of a $0.30 per dth could be considered aggressive, but even Southwest's scenario four, which does not reflect any basin differential over the 12 year period, shows that taking service from Transwestern would not greatly impact Southwest's overall cost of gas.

For other charges, Southwest indicates it anticipates a usage charge of $[redacted] per dth, a fuel rate of [redacted] percent, and an Annual Charge Adjustment ("ACA") surcharge (the FERC regulatory assessment) of $0.0018 per dth.

In summary, given the relative similarity of the projected costs for Southwest to take service from El Paso or Transwestern, intangible benefits, such as the introduction of pipeline competition into central Arizona, weigh heavily in deciding whether pre-approval is warranted in the proceeding.

Southwest Method for Recovering Transwestern Costs

The Transwestern costs proposed for recovery are standard pipeline service related costs. Southwest currently recovers its costs related to pipeline service from El Paso via its purchased gas adjustor ("PGA") mechanism. Southwest's costs related to taking pipeline service from Transwestern should be recovered in the same manner, through the PGA mechanism. Southwest would not incur costs for service on Transwestern until Southwest would begin to take service from Transwestern, likely sometime in [redacted] based upon current projections, so such costs would not likely begin to be passed along to Southwest customers until [redacted].

Right-of-Way Issues and Construction of New Pipelines in Arizona

Siting a major new pipeline in Arizona requires the securing of many miles of right-of-way access and given the many entities which hold land in Arizona and numerous potential restrictions, it can be difficult to secure the necessary right-of-way to construct new infrastructure in Arizona. The Transwestern project would require right-of-way in fast-growing areas, including in the Prescott and Phoenix metro areas. It appears that Transwestern should be able to secure the necessary right-of-ways to move forward with the Phoenix lateral. However, if for some reason this Transwestern project does not move forward or is delayed significantly, it will become increasingly difficult for Transwestern or another entity to secure the necessary right-of-way access to build a new pipeline into central Arizona, due to growing encroachments from development. Given the variety of siting issues faced by infrastructure developers in Arizona and the continued rapid growth in Arizona, it is reasonable to believe that the ability to site a new pipeline will be significantly diminished in the near future and that it may become impractical or economically prohibitive in the coming years to build such a new pipeline. While not a compelling reason to approve Southwest's application in and of itself, the increasing difficulty of siting infrastructure does indicate there is some benefit in moving forward with such a project in a timely manner.

El Paso Natural Gas Company Comments and Filings

On March 14, 2006, El Paso filed for intervention in this proceeding. On March 28, 2006, El Paso was granted intervention in this proceeding. El Paso indicates in its application for intervention that this proceeding could impact El Paso in a number of ways, including that El Paso could provide the same or superior service at a lower cost, El Paso's planning for future construction in Arizona, and El Paso's ability to compete in capital markets for financing of facilities.

In the previously referenced proceeding dealing with APS' pre-approval application, El Paso expressed concerns that it did not have the opportunity to provide its full analysis of the application and fully participate in the Commission's process. Staff has worked to ensure that all parties, including El Paso, have had the opportunity to participate meaningfully in the process without delaying the processing of Southwest's application.

In this proceeding El Paso has provided Staff with a variety of information for Staff consideration in analyzing Southwest's application. On April 19, 2006, El Paso provided Staff with a confidential analysis of the Southwest application, conducted by Navigant Consulting ("Navigant"), an outside consultant hired by El Paso to review Southwest's application, including confidential materials related to Southwest's agreement with Transwestern. It is worth noting that the author of this report for Navigant, Richard Smead, served as a Vice President of Regulatory Policy for El Paso from 2001-2004. On April 20, 2006, El Paso provided Staff with a variety of other materials related to Southwest's service on El Paso, addressing sculpted volumes, contract pathing allocations, Southwest's gas supply information by supply basin, Transcolorado Gas Transmission Company's open season on its Blanco-Meeker expansion project, and production disruptions in the San Juan basin due to cold weather.

The report prepared by Navigant raises a number of issues for the Commission to consider in evaluating Southwest's application. Some other sections of this report address issues raised by the report prepared by El Paso's consultant at least to some extent, but the following section will provide a summary of Staff's review of the Navigant report as well as the other information provided by El Paso.

Staff Discussion of the Navigant Report

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

In general Staff believes that Navigant's review provides a reasonable comparison of a number of issues regarding service on Transwestern and El Paso. In total, Staff does not believe that Navigant's analysis provides a compelling argument in favor of or against Southwest's participation in the Phoenix Project. Additionally, Navigant's report does not address several important issues which the Commission has considered in past pre-approval applications, such as the value of pipe-on-pipe competition and the growing difficulties of siting a new natural gas pipeline in Arizona in the future. While these issues are difficult to quantify in a meaningful way, they are nonetheless very important public policy considerations which the Commission should weigh in evaluating Southwest's application and its long-term impact on natural gas markets in the Southwest.

Southwest's Application as Part of the Broader Scope of the Transwestern Project

[redacted]

The Commission Notice of Inquiry on Natural Gas Infrastructure

On April 15, 2003, the Commission initiated its Notice of Inquiry ("NOI") on natural gas infrastructure, issuing a list of questions to solicit input from interested parties. A total of 20 parties provided responses to the NOI questions. On September 10, 2003, the Commission held a workshop regarding the NOI on natural gas infrastructure. Prior to the workshop, Commission Staff had circulated a strawman proposal for discussion at the workshop. Following the September 10, 2003 workshop, the Commission solicited an additional round of comments from interested parties regarding the strawman proposal and other issues discussed at the workshop. Comments were received from 17 parties following the September 10, 2003 workshop.

On December 18, 2003, the Commission issued its Policy Statement Regarding New Natural Gas Pipeline and Storage Costs. In this document, the Commission made specific policy statements about supply/infrastructure diversity, supply/infrastructure planning, the Commission approach to new infrastructure projects, the general Commission approach, individual utility circumstances, and reporting.
The policy statements included in the December 18, 2003 document, are as follows:

I. Supply/Infrastructure Diversity

1. *Diversity in Arizona's natural gas infrastructure, including interstate pipeline facilities, natural gas storage facilities, and related aspects of natural gas service, is beneficial and should be actively pursued by Arizona utilities as a way of providing greater supply reliability and flexibility and possible lower costs.*

2. *Arizona utilities as a general principle should pursue a diverse natural gas supply portfolio which takes into account relevant factors including cost, reliability, flexibility, safety, and price stability.*

3. *Arizona utilities should consider natural gas storage as an integral component of their efforts to develop a diverse natural gas supply portfolio, recognizing the variety of potential benefits of natural gas storage, including enhanced reliability, operational flexibility, more efficient use of pipeline capacity assets, and reduced natural gas price volatility.*

4. *The current monopoly on interstate pipeline service in central and southern Arizona is not beneficial to the state of Arizona. The Commission encourages development of alternative natural gas supply options, including one or more new interstate pipelines and natural gas storage facilities. Reduction over time of Arizona's reliance on a single pipeline system reduces the risk to Arizona of operational, regulatory, or other problems which may occur in regard to any given pipeline system.*

II. Supply/Infrastructure Planning

1. *Arizona utilities should plan for natural gas infrastructure needs on a long term basis, recognizing that some decisions may not necessarily lead to the lowest cost in the short term. Such planning should take into account the lead time necessary to construct and put in service natural gas infrastructure in Arizona.*

2. *The Commission endorses voluntary efforts to analyze and plan for the present and future natural gas supply needs of Arizona and encourages Arizona utilities and others to actively participate in such activities.*

III. Commission Approach to New Infrastructure Projects

1. *The Commission, as a general proposition chooses not to endorse specific infrastructure projects. The Commission believes that the region's natural gas consumers and infrastructure developers play a fundamental role in determining how to best address the region's infrastructure needs. The Commission anticipates*

continued active involvement in FERC proceedings related to Arizona's natural gas infrastructure, as the Commission deems appropriate.

IV. General Commission Approach

1. *The Commission NOI on natural gas infrastructure activities recognizes the jurisdiction and central role of FERC in developing new natural gas infrastructure in the Southwest and anticipates the Commission's NOI initiative as being complementary to FERC's activities, recognizing that both state and federal regulators can play a role in Arizona's natural gas infrastructure development.*

2. *The Commission encourages open, on-going and substantive communication between Arizona utilities and the Commission as Arizona's natural gas infrastructure is developed in the coming years.*

3. *At this time the Commission believes that the best method for the Commission to address natural gas infrastructure matters is to encourage utilities to file applications, including requests for alternate cost treatment, in order that the Commission can consider specific requests for cost recovery proposals appropriate to the circumstances for each individual application.*

V. Individual Utility Circumstances

1. *As individual Arizona utilities consider their participation in the development of natural gas infrastructure, the Commission recognizes that each utility's circumstances and needs are unique and participation in natural gas infrastructure projects will vary accordingly.*

VI. Reporting

1. *Reporting for any additional pipeline services should be consistent with the method and content of current reporting by utilities for their current pipeline services.*

2. *Reporting requirements for natural gas storage activities will need to be developed, given the lack of current natural gas storage availability in Arizona. Utilities should work with Staff to develop the proper reporting format and content to be included in reports to the Commission, including possibly through existing monthly adjustor reports or other reporting methods as deemed appropriate.*

The document also discusses the Commission's consideration of alternate cost recovery methods, such as pre-approval, as well as the way such costs have traditionally been considered and that the traditional method is the preferred way.

On February 13, 2004, the Commission held another workshop regarding the NOI on natural gas infrastructure. Topics of discussion at the workshop included Arizona natural gas infrastructure issues, updates on pending pipeline and gas storage projects, and the National Petroleum Council study, *Balancing Natural Gas Policy: Fueling Demands of a Growing Economy*, which was issued in September 2003.

Previously both APS and Southwest made pre-approval filings related to Kinder Morgan's proposed Silver Canyon pipeline project with the Commission in Docket Nos. G-01551A-04-0192 and G-01345A-04-0273. In Decision Nos. 67091 (June 29, 2004) and 67239 (September 15, 2004), the Commission approved the Southwest and APS applications respectively, subject to a number of conditions. Additionally, as noted previously, the Commission approved an APS filing for pre-approval of costs related to acquiring pipeline capacity on the Phoenix Project.

What Does Pre-approval Mean and Why Pre-approve?

Southwest's application in this matter specifically requests Commission pre-approval of the costs identified in the application for recovery. As stated in the December 18, 2003 Commission Policy Statement Regarding New Natural Gas Pipeline and Storage Costs:

> "Traditionally Arizona entities have not sought and the Commission has not granted pre-approval of cost recovery from participation in infrastructure projects or other projects. Rather utilities made their own business decisions on those projects. At a later time the Commission addressed cost recovery in proceedings such as rate cases and adjustor mechanisms. One important reason for this traditional approach has been to ensure that the Commission has a full opportunity to evaluate the actions taken and costs incurred by the utility for prudency and in the best interest of Arizona's utility consumers. This approach provided incentive to utilities to pick the most cost-effective project. This traditional approach to utility participation in infrastructure projects, including natural gas pipeline and storage projects, is still available to utilities that wish to continue using this method."

While the traditional method should still be the standard way to address participation in such infrastructure or other projects, the unique and extraordinary circumstances present in Arizona's natural gas infrastructure at this time support Commission consideration of new methods which may enhance the state's ability to address natural gas infrastructure concerns in a more timely manner.

One concern that is expressed at times regarding the traditional method is that a utility will have a strong inclination to always pick the least cost option because it is often considered the easiest to justify in the future when the Commission scrutinizes its actions, even if there are strong considerations which indicate that an option other than the least cost option may be a reasonable and viable course of action. Recognizing that each case must be measured on its own merits, there certainly are cases where less tangible benefits may be substantial and outweigh a higher cost, at least in the short term. One can argue that such a case currently exists in considering the development of Arizona's natural gas infrastructure.

For example, it is widely recognized in the natural gas industry that having competition between multiple pipelines to serve a given area is a positive benefit. This harks back to basic economics as a seller of a good in a market with no competitors is not likely to have the same motivation to reduce the price of the good as that seller would have if there were one or more other competing sellers of the same good in the same market. Applying this reasoning to the Southwestern natural gas market, one could make the argument that El Paso does not have the same motivation to reduce the cost of service to its Arizona shippers (with no pipeline competition in Arizona) as it does to reduce the cost of service to its California shippers (who have multiple pipeline options, including the recently concluded expansion of the Kern River pipeline). The introduction of another pipeline to central and southern Arizona, such as the Transwestern pipeline, would introduce at least some level of pipeline competition to the major Arizona markets.

Certainly, utilities may choose to pursue other pipeline options absent pre-approval of such actions, but taking such action is likely more difficult in the current market with so much uncertainty. Also, it would appear that the financial difficulties being experienced by many entities in the energy business would lessen the industry's appetite as a whole to participate in new infrastructure projects, even if they are needed and beneficial. Given the unique circumstances and needs of the Arizona natural gas market at this time, providing properly conditioned pre-approval in the current circumstance could provide an additional incentive for Arizona utilities to participate in infrastructure projects which at least on an up-front cost basis may appear more costly than the existing infrastructure option.

Southwest specifically has requested pre-approval for recovery of the reservation charges, volumetric rate, fuel rate, and applicable surcharges associated with the Transwestern project. Other costs Southwest could incur are not being considered in this proceeding. Pre-approval in this case would reflect Commission approval to recover those previously identified specific costs for the period of the initial contract with Transwestern. Such costs would not begin to be incurred until such time as the pipeline project is built and Southwest begins taking service through the pipeline, currently projected to be in [redacted]. Southwest is currently incurring similar pipeline capacity costs for its pipeline capacity on the El Paso system. As a general principal, pipeline capacity costs on different pipelines should be recovered in a similar manner to avoid providing an artificial incentive to favor pipeline capacity on one pipeline over another.

However, while pre-approval would provide for the recovery of these costs from ratepayers, it would not in any way reduce the Commission's ability to determine the prudency of the operation and use of Southwest's pipeline capacity rights, whether on the Transwestern pipeline or other pipelines. Southwest still has a standing obligation to maximize the value of all its pipeline capacity assets for the benefit of the Southwest ratepayers who pay for the capacity. So if the Commission in the future determined that Southwest had not prudently managed its Transwestern or other pipeline capacity, it could take action to disallow such costs, just as the Commission can do with Southwest's present pipeline capacity.

It should be noted that even if the Commission provides pre-approval of Southwest's participation in the Transwestern project, the project, for a variety of reasons, could still end up not being constructed. However, it does appear that Commission pre-approval would positively impact the Transwestern project's likelihood of moving forward.

Southwest's Participation in the Transwestern Project in Light of the Commission's December 18, 2003 Policy Statement

The Commission's December 18, 2003 policy statement addressed a number of policy issues related to new natural gas infrastructure in Arizona. This section of the Staff Report considers how Southwest's application conforms to the Commission's December 18, 2003 policy statement.

Section one of the policy statement addresses supply/infrastructure diversity. Southwest's Transwestern capacity would provide additional natural gas infrastructure diversity, would enhance Arizona's access to San Juan and Rockies gas, and would help reduce the current monopoly pipeline service situation existing in central and southern Arizona.

Section two of the policy statement addresses supply/infrastructure planning. Southwest's participation in the Transwestern project does represent an effort to undertake long-term planning for Southwest's natural gas needs, recognizing that a great deal of uncertainty exists regarding pipeline service in the Southwest in the coming years.

Section three of the policy statement addresses the Commission's approach to new infrastructure projects. As previously noted, the Commission in this proceeding is in no way providing a specific endorsement of the Transwestern pipeline project in comparison to other projects, but is rather assessing the individual circumstances represented in Southwest's filing.

Section four of the policy statement addresses the general Commission approach. Southwest's application is consistent with the Commission's indication that it would consider specific requests by utilities for cost treatment of new infrastructure costs.

Section five of the policy statement addresses individual utility circumstances. Southwest's application is reflective of the individual pipeline capacity and service needs of

Southwest and its customers through such features as seasonal capacity focused on summer cooling season months as well as daily operational flexibility.

Section six of the policy statement addresses reporting requirements. Southwest has indicated a willingness to provide information to the Commission regarding its Transwestern capacity.

In summary, Southwest's filing addresses a number of the policy issues which the Commission's December 18, 2003 policy statement identifies for Arizona energy consumers.

Impact of Pre-approval on Southwest's Level of Risk

Southwest, as a public service corporation providing natural gas service in Arizona, is subject to a variety of risks as it conducts its business. As a general principal, utilities such as Southwest attempt to reduce the level of risk they face, as a reduced risk level is looked upon favorably for a variety of reasons. Southwest's risk is typically one factor which is considered in certain Commission proceedings, including general rate proceedings. Pre-approval of the cost of acquiring a given asset, would seem to shift some level of risk from the Company to the ratepayers. In this case, if the Commission grants pre-approval of Southwest's acquisition of Transwestern capacity, it would seem to reduce Southwest's risk in relation to this particular asset. The question of what this apparent reduction of risk means to Southwest's overall level of risk is a more difficult question, as Southwest faces a variety of different risks, both in its gas supply acquisition activities, and in various other segments of its business. Southwest has indicated that it does not believe that Commission pre-approval of the acquisition of Transwestern capacity has a discernable impact on Southwest's level of risk. Whether there is a discernable impact on Southwest's risk and if so, what the proper treatment of the shift in risk would be are issues which are more properly considered in future Southwest rate proceedings, when risk and other matters are considered in setting Southwest's rates. In such future rate proceedings, all parties can review this issue and make recommendations as to the proper treatment of any shift of risk resulting from Commission pre-approval in this proceeding. Therefore, Staff recommends that any effect pre-approval of this project may have on Southwest's risk be determined in a future rate proceeding.

Conclusions and Recommendations

Southwest's natural gas consumption in Arizona has gradually grown in the past, reflecting the growth in population and economic activity in Arizona, and it is reasonable to think that such growth in consumption will continue in the near term future. The primary options for such additional capacity are to acquire more pipeline capacity as it becomes available on the El Paso system or to contract with a new pipeline developer such as Transwestern. The proposed Transwestern project provides a number of benefits to Southwest, including greater supply diversity, a competitive pipeline in central Arizona, the potential formation of a market center in Arizona, a good deal of operational flexibility, and a good measure of rate and operational certainty. The risk of paying higher costs from taking service from Transwestern instead of El Paso is relatively limited and could swing the opposite direction in some cases. Staff believes that there is a strong potential that over time that the cumulative effects of the construction of the Transwestern pipeline could actually lead to lower overall natural gas costs for Southwest, benefiting the utility's customers.

Given the comparability of total costs from taking service from El Paso or Transwestern, Staff believes that the many other benefits of the Transwestern project, both tangible and intangible, argue strongly for Commission pre-approval of cost recovery for Southwest's participation in the Transwestern project as outlined in Southwest's application and discussed herein. Southwest's acquisition of capacity on the Transwestern project addresses a number of policy goals contained in the Commission's December 18, 2003 policy statement. The end result of construction of the Transwestern project would be a more vibrant, more diverse, more competitive natural gas infrastructure in Arizona which would benefit Southwest. Such developments would also benefit other central Arizona shippers including local distribution companies, municipal utilities, incumbent electric utilities, merchant power generators, and end-users. Staff believes that Southwest's application reflects many of the same issues the Commission considered in pre-approving APS' pre-approval application in February 2006.

Staff believes that Southwest's participation in the Transwestern project is reasonable given the information available at this time. Staff recommends that the Commission pre-approve Southwest's specific costs (reservation charges, volumetric rate, fuel rate, and applicable surcharges) discussed herein related to the proposed Transwestern pipeline project, subject to the conditions listed below.

Proposed Conditions to Pre-approval:

1. The Commission retains full authority to review Southwest's gas procurement activities, including its management of all pipeline capacity and related activities, recognizing that the Commission is pre-approving the underlying acquisition of the Transwestern capacity during the initial term of the agreement with Transwestern. The pre-approval being granted in this proceeding would expire upon completion of the initial term.

2. The impact, if any, on Southwest's risk profile resulting from pre-approval of costs related to Transwestern pipeline capacity would be considered within the context of future Southwest rate proceedings.

3. Southwest shall file a status report on the Transwestern project and Southwest's participation in the project with the Commission every six months until either Southwest begins taking service from Transwestern or Southwest's participation in the project is terminated.

4. Southwest shall file a notice with the Commission, within ten days of when the exact volumetric and fuel rates, applicable for Southwest when Southwest begins service with Transwestern, are set for the Transwestern pipeline.

5. Southwest shall file a notice with the Commission within ten days of each of the following events regarding the Transwestern project: a) Transwestern filing with FERC for approval of the pipeline, b) FERC granting approval of the pipeline, c) Transwestern beginning construction of the pipeline, d) Transwestern completing construction of the pipeline, and e) Southwest beginning to take service from the Transwestern pipeline.

6. Southwest shall file a notice with the Commission if at any time either Southwest or Transwestern exercises termination rights pursuant to the precedent agreement or if any other events significantly impact Southwest's participation in the Transwestern project, within ten days of any such action.

7. Pre-approval of the specific costs related to Southwest's acquisition of capacity on the Transwestern pipeline is granted based upon the specific and unique conditions considered in this application and will in no way commit or predispose the Commission regarding any future considerations of pre-approval of costs. Rather, the standing presumption would be that the Commission would not grant pre-approval in future proceedings, absent a careful consideration of unique, serious, and important circumstances which would require such action.

8. None of the pre-approved costs will be passed on to Southwest's ratepayers until all of the following occur:

   - The Transwestern pipeline is built and operational.

   - Southwest is receiving service on the Transwestern project consistent with the precedent agreement and this order.

9. The pre-approved costs shall be passed on to Southwest customers through its Purchased Gas Adjustor.