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MEMORANDUM

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TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: August 22, 2006

RE: STAFF REPORT ON SOUTHWEST GAS CORPORATION COMPLIANCE MATTERS RELATED TO ITS 2005 RATE PROCEEDING (DOCKET NO. G-01551A-04-0876)

Attached is the Staff Report for compliance matters related to its 2005 rate proceeding.

EGJ:BGG:red

Originator: Bob Gray

Attachment: Original and Thirteen Copies

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

SOUTHWEST GAS COMPLIANCE MATTERS RELATED TO ITS 2005 RATE PROCEEDING

DOCKET NO. G-01551A-04-0876

AUGUST 22, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Southwest Gas Compliance Matters Related to Its 2005 Rate Proceeding, Docket No. G-01551A-04-0876, was the responsibility of the Staff members listed below.

Robert Gray
Senior Economist

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Introduction

On February 23, 2006, the Commission issued an order in Southwest Gas Corporation's ("Southwest") rate proceeding before the Arizona Corporation Commission ("Commission") in Docket No. G-01551A-04-0876. The order discusses a number of matters that require further actions by Southwest and discussions with Staff, followed by a report from Staff to the Commission. Specifically, ordering paragraphs on page 68 of the order state:

> "Southwest shall initiate discussions with Staff, within 60 days of this Decision, regarding stock ownership issues discussed herein, and to continue to cooperate with Staff regarding other procurement issues, including issues pertaining to El Paso and construction and ownership of laterals on the Company's system." (lines 18-21)

> "Staff shall file within 180 days of the effective date of this Decision, as a compliance item in this docket, a report or reports regarding stock ownership issues, procurement practices, benchmarking, and El Paso laterals issues discussed above." (lines 22-24)

Southwest did initiate discussions with Staff within 60 days of the decision, and this document is Staff's report to the Commission, as required within 180 days of the decision (by August 22, 2006). In this Staff Report, there is a brief discussion of each issue identified in the order for Staff to report on. In general, Staff believes that Southwest's efforts to comply with Decision No. 68487's requirements are consistent with the order.

Procurement Practices

During the rate proceeding, Staff recommended a number of changes regarding Southwest's procurement practices, including separating the contract award group from the invoice approval authority, eliminating the use of cell phones in term bidding and negotiating activities, and having a neutral party observe these activities. Southwest agreed to implement these changes during the rate proceeding.

On April 24, 2006, Southwest filed a letter in the rate case docket. The letter states that Southwest has completed making changes to implement the recommendations discussed above regarding procurement practices. Southwest has provided Staff with additional information, including internal memos, work orders, organizational charts and other information, documenting the changes Southwest agreed to make during the rate proceeding. Further, Staff anticipates making a future site visit to observe Southwest's acquisition practices, during which Staff could visually verify implementation of these changes.

Benchmarking Study

Southwest hired Ralph Miller, a consultant, to conduct a benchmarking study of Southwest's gas procurement practices. The report discusses various aspects of Southwest's procurement policies and procedures and compares them to industry practices. Areas covered by the review include load forecasting, capacity acquisition, and commodity procurement. The report includes discussion of an American Gas Association ("AGA") study on gas portfolio management during the 2004-2005 winter season by AGA members.

Southwest has an annual planning period which runs from November through December each year, a common industry practice according to the report. The report notes that Southwest's load forecast is comprehensive, including major components such as:

- Annual, seasonal, and monthly loads under normal weather conditions.
- Design day, design week, and design winter season loads.
- Maximum and minimum daily loads that may occur in each calendar month.

The report indicates that no-notice and swing requirements (used to meet short term fluctuations in customer demand for natural gas) are implicitly included in the components identified above. The report concludes that Southwest's load forecasting process is complete and comprehensive and provides the information needed for Southwest's gas procurement activities. The report notes that it does not address the specific methods Southwest uses to prepare its load forecast or the quality of the load forecast.

Regarding capacity acquisition, the report notes that Southwest's overriding consideration is that its Arizona city gates are connected only to the El Paso Natural Gas interstate pipeline system, and for most if not all city gates, it would be difficult and expensive to connect to another pipeline. The report does note the prospect of the Transwestern Pipeline Phoenix Project entering the Phoenix market in 2008. The report indicates that Southwest's capacity portfolio is further restricted by the limited services offered by El Paso and the lack of market area natural gas storage in Arizona. The report states that Southwest continuously reviews alternative options for gas delivery to Arizona, but notes that the consideration of alternative delivery options does not impact the actual procurement of gas supplies until such time as Southwest actually acquires alternative capacity.

The report discusses five components of Southwest's commodity purchase portfolio, including fixed price purchases, term contracts for firm baseload supplies in the winter season, term contracts for peaking supplies in the winter season, monthly baseload supplies at current spot prices in the summer season, and daily spot purchases for swing supplies in the summer season.

The report also compares a number of characteristics of Southwest's gas procurement activities to the results of the AGA's study of local distribution company ("LDC") practices during the 2004-2005 winter season. The report indicates that Southwest's structure of its term contracts is consistent with other LDCs. Southwest relies on peaking supplies and daily spot purchases much more than most other LDCs, but this is a necessary result given the lack of market area storage (storage in the areas where natural gas is consumed) in Arizona. The report indicates that Southwest has considered acquiring production area storage (storage where natural gas is produced) but found it to be uneconomic. The report discusses Southwest's use of intermediate term baseload purchases of one to twelve months, with such purchases being made either on the basis of a fixed purchase price, a use of a basis differential with a NYMEX component, and via index pricing. The report also talks about Southwest's use of swing and daily spot purchases. Southwest makes daily purchases using a combination of fixed pricing and index pricing, a common LDC practice.

The report also contains a section that deals with Southwest's price risk management efforts, which Southwest refers to as its Arizona Price Stability Program ("APSP"). The report indicates Southwest manages its price risk by acquiring approximately half of its gas supplies through fixed price contracts with prices established up to 24 months in advance. The report evaluates three aspects of the APSP, including the size of the program, alternative price risk management strategies, and the use of financial instruments instead of fixed price purchase contracts. The report states that Southwest's APSP is large but reflective of the unusual supply situation Southwest faces, given the lack of market area storage which many LDCs around the country have access to. The report indicates that Southwest's extensive use of fixed price contracts helps offset the lack of market area storage.

The report indicates that the other option for Southwest to manage price risk is for Southwest to acquire call options, which would allow Southwest to acquire gas at the strike price of the option or alternatives including puts and collars. The report discusses the pros and cons of these options before concluding that such options should generally only be a relatively small supplement to a fixed price purchase program and notes that LDCs the author is aware of only use such options for a small part of their portfolio.

The report then discusses the use of other financial instruments such as swaps and NYMEX futures contracts as other options to acquire natural gas at a fixed price. The report notes that Southwest has been looking into using such financial instruments, and this is consistent with movement by a number of LDCs around the country to make greater use of financial instruments. The report notes benefits from use of these financial instruments including the ability to hedge some swing or peaking supplies and the reduction in risk of a counter-party defaulting.

Attached to Southwest's report are a number of items, including several tables showing loads and demands, qualifications of the consultant, and the AGA's report on LDC Supply Portfolio Management During the 2004-2005 Winter Heating Season. Southwest also attached a document providing an overview of Southwest's financial hedging policy and processes for its gas supply portfolio. This overview document included five sections dealing with policy, governance structure, processes and controls, the hedge capture and control system, and the code of ethics.

The report summarizes with a number of conclusions about Southwest's gas procurement activities, including:

- Southwest's purchasing practices are generally consistent with practices of well-managed gas utilities.
- Southwest's use of a competitive bidding process to secure fixed price and term contracts, acquisition of fixed price purchases on a periodic basis, and use of informal solicitations to acquire spot purchases are consistent with the practices of other gas utilities.
- Southwest's APSP relies more heavily on fixed price purchases to hedge approximately half of its natural gas supplies. This reliance on fixed price purchases is greater than a typical gas utility due to the lack of natural gas storage facilities in the market area to assist in Southwest's hedging efforts.
- Southwest acquires the other half of its gas supplies using pricing arrangements that reflect current market conditions, including use of negotiated prices and index pricing.

Review of Gas Portfolio Evaluation Software

In the rate proceeding, Staff recommended that Southwest review its gas portfolio evaluation software. Southwest's July 7, 2006 report contains a discussion of Southwest's portfolio evaluation software review.

For many years Southwest has used a software package known as UPLAN-G, owned and developed by LCG Consulting. This software is used by Southwest to determine a least cost mix of resource contracts, taking into account a variety of factors including forecasted demand, available interstate resources, and contract pricing.

Southwest identified three groups of available software, including macroeconomic models, transactional models, and optimization and dispatch models. Macroeconomic software models flows of natural gas on a regional basis on the basis of supply, demand, price, and available infrastructure facilities. Transactional software enables an LDC to track transactions related to the purchase, transportation, and sale of natural gas. Southwest concluded that macroeconomic and transactional software would not enable Southwest to effectively optimize its portfolio of supply resources, due to the nature of these kinds of software.

Optimization and dispatch models enable an LDC to optimize its selection of resources. Southwest indicated that two optimization and dispatch models are currently available in the natural gas industry, UPLAN-G, which Southwest currently uses, and a software program named Sendout. Southwest states that a review of Sendout did not identify any functionality that would be gained by Southwest that would warrant switching from its current modeling software. Southwest indicated that it will continue to evaluate developments in modeling software and will inform Commission Staff of developments in this area.

Stock Ownership Issues

Southwest's Code of Business Conduct and Ethics currently contains a list of statements of things that Southwest considers to be in conflict with an employee's duties and contrary to Company policy. One of these statements says: "Holding any substantial stock or other financial interest in any competitor, supplier, contractor, or vendor or other organization with which an employee is engaged in a business relationship. If there is any question as to whether the interest is substantial, you should seek advice from the General Counsel."

In the rate proceeding, Staff expressed a concern with the lack of clarity regarding potential ownership of stock or other financial interests in counterparties, and Staff recommended that Southwest preclude stock ownership or other financial interest with any supplier or class of suppliers with which they do business. In early July Southwest provided Staff with a draft document providing a more clear definition of what Southwest viewed as being "substantial." In essence, this draft document indicated that if a Southwest employee owned more than 1 percent of the equity in a counterparty, that would be considered substantial.

Staff has had several follow-up discussions with Southwest regarding this issue. Staff has expressed concern that one percent of some counterparties, such as a major natural gas producer/marketer, could be a very large amount of money, while also recognizing that Southwest has a number of other policies and procedures in place that provide checks and balances on an employee possibly conducting procurement activities in a manner that would be inconsistent with Southwest or ratepayers' interests.

Southwest provided Staff with additional documentation regarding the Company's efforts to develop its stock ownership definition and how it fits within Southwest's overall controls and procedures.

In developing its stock ownership definition and related documents, Southwest cites a number of steps Southwest took, including:

- A review of the policies, procedures, and controls of the gas procurement and purchasing departments.
- A review of the Codes of Ethics and Business Conduct including the Conflict of Interest Policies of Unisource Energy Corporation and Arizona Public Service Company. Southwest found that its policies are similar to the policies of those companies.
- Via Southwest's Assistant General Counsel, Southwest queried approximately 30 other companies at a recent American Gas Association Legal Committee meeting, and none of the other companies' representatives indicated they had stock ownership restrictions beyond their code of ethics and business conduct.
- Development of a stock ownership disclosure form in addition to Southwest's existing conflicts of interest form that is distributed to all employees.

Regarding Southwest's gas procurement department, Southwest identifies a number of policies and procedures which help ensure that Southwest employees are not conducting themselves in a manner that could favor an entity they had a financial interest in, including:

- Southwest's strong motivation to buy the lowest price natural gas supplies due to competitive pressures.
- Periodic regulatory reviews of Southwest's purchasing practices.
- Use of a blind bid selection process for fixed price and first of the month purchases where the person awarding the contract does not know the identity of the supplier.
- For daily spot or term portfolio purchases, Southwest only purchases from the lowest priced qualified bidder.
- Solicitations are sent out to a standard list of suppliers by the department secretary, not the gas buyer and a neutral party observes the solicitation process.
- Periodic external and internal audits.
- Requiring employees to sign conflict of interest forms.

Southwest indicates that the purchasing department has similar controls to the gas procurement department. Southwest has not completed the process of designing its stock ownership policy and related materials, and Southwest has agreed to provide Staff with such further materials and documents when they are completed. Southwest has also agreed to have further discussions with Staff on these issues as necessary.

El Paso Lateral Issues

In the rate proceeding Staff had put forth a recommendation that Southwest should construct its own laterals (rather than having El Paso construct them) unless there is a compelling reason to do otherwise. Most of Southwest's load is served off of El Paso's lateral system in Arizona and proposals by El Paso in its on-going rate proceeding at the Federal Energy Regulatory Commission ("FERC") would make it difficult if not impossible for Southwest to access service from another pipeline or storage service provider for these loads. This recommendation came from Staff's on-going concern about El Paso's use of its lateral system as one of several means to stifle competition from potential third party storage and/or pipeline developers in Arizona. To the extent laterals are owned by Arizona entities, rather than El Paso, Arizona entities such as Southwest may be able to lessen the effects of such anti-competitive behavior. Staff has had discussions with Southwest and believes that Southwest and Staff have similar views on the issue of laterals.

Options available to Southwest to meet new or growing demand for natural gas in Arizona include construction of new laterals, expansion of existing laterals, and/or acquisition of existing laterals from El Paso. Southwest has acquired laterals from El Paso in the past, including 2001 acquisitions of the Buckeye, Rainbow Valley, Parker, and Elfrida laterals. Southwest has indicated that another factor influencing its possible acquisition of laterals is El Paso's positioning of itself in the Arizona market and that at times Southwest would like to acquire laterals from El Paso, but El Paso may not be interested in such transactions for a variety of reasons. Southwest weighs a variety of factors related to a possible acquisition from El Paso, including:

- The need for additional capacity.
- Bypass potential of Southwest's core customers.
- Potential higher delivery pressure benefits.
- Ability to access other supplies.
- El Paso's current limitations on Southwest's use of the lateral.
- Possible reductions in needed Southwest facility expansions on its distribution system.
- Reduced need for additional interconnects with El Paso.
- Benefits from acquisition of rights-of-way.

If Southwest makes a preliminary determination that an acquisition is cost-effective, it undertakes a detailed Acquisition Review Plan. The plan involves an analysis of pipeline capacity, original design and materials, installation records and practices, operational and maintenance records, compliance and safety issues, rights-of-way, environmental issues, modifications required for acquisition, and a final cost-benefit analysis. Southwest would then consider the totality of these issues and make a decision.

Staff understands and agrees with Southwest's approach to weigh all of these various factors when considering an acquisition from El Paso or other options and supports Southwest conducting a thorough evaluation of its alternatives. Staff still supports a policy of encouraging Southwest to own infrastructure rather than having El Paso construct, operate, and own infrastructure, while recognizing that Southwest, subject to the unique circumstances present in certain cases, may choose to not own or construct infrastructure sometimes and that such decisions may be in the best interests of Arizona ratepayers' long term interests. Staff and Southwest also discussed having further discussions in the future regarding Southwest's planning and actions to meet its current and future infrastructure needs.

Conclusions

Staff believes that Southwest's efforts in the areas described in this report are consistent with the requirements of Decision No. 68487 for Southwest to work with Staff on these issues, subject to further discussions and efforts as discussed herein. Some areas of interest in this report, including gas procurement related matters and El Paso lateral issues are matters of on-going interest as circumstances continue to develop in Southwest's Arizona service territory and across the region, and therefore Staff anticipates continued, on-going discussions with Southwest regarding these matters.