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TO: THE COMMISSION

AZ CORP COMMISSION
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FROM: Utilities Division

DATE: January 29, 2007

RE: IN THE MATTER OF UNS GAS, INC. FOR PRE-APPROVAL OF COST RECOVERY FOR THE ACQUISITION OF PIPELINE CAPACITY ON THE TRANSWESTERN PHOENIX EXPANSION PROJECT (DOCKET NO. G-04204A-06-0627)

On October 23, 2006, UNS Gas Inc. ("UNS" or "Company") filed for Commission pre-approval of cost recovery for participation in the Transwestern Pipeline Phoenix natural gas pipeline project ("Phoenix Expansion Project"). The Phoenix Expansion 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, passing through Yavapai County in the Prescott area. UNS' 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. UNS' application is the third request for pre-approval related to the Phoenix Expansion 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 Expansion Project (Decision Number 68597, March 23, 2006), subject to certain conditions. The Commission also previously approved an application by Southwest Gas for pre-approval of certain costs related to pipeline capacity on the Phoenix Expansion Project (Decision Number 68753, June 6, 2006). This Staff Report represents Staff's evaluation and recommendations regarding this UNS filing.

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

E.G.J.

Ernest G. Johnson
Director
Utilities Division

EGJ:RGG:tdp\JMA

ORIGINATOR: Robert Gray

Arizona Corporation Commission
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JAN 30 2007

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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: January 30, 2007

RE: STAFF REPORT FOR UNS GAS, INC. APPLICATION FOR PRE-APPROVAL OF COST RECOVERY FOR THE ACQUISITION OF PIPELINE CAPACITY ON THE TRANSWESTERN PHOENIX EXPANSION PROJECT (DOCKET NO. G-04204A-06-0627)

Attached is the Staff Report for the UNS Gas application for pre-approval of cost recovery for the acquisition of pipeline capacity on the Transwestern Phoenix Expansion Project. Staff recommends approval, subject to certain conditions.

EGJ:RGG:tdp

Originator: Robert Gray

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Docket No. G-04204A-06-0627

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

UNS GAS, INC.

DOCKET NO. G-04204A-06-0627

APPLICATION FOR PRE-APPROVAL OF COST RECOVERY FOR THE ACQUISITION OF PIPELINE CAPACITY ON THE TRANSWESTERN PHOENIX EXPANSION PROJECT

JANUARY 23, 2007

STAFF ACKNOWLEDGMENT

The Staff Report for UNS Gas Inc., Docket No. G-04204A-06-0627, was the responsibility of the Staff member listed below.

Robert Gray
Public Utilities Analyst V

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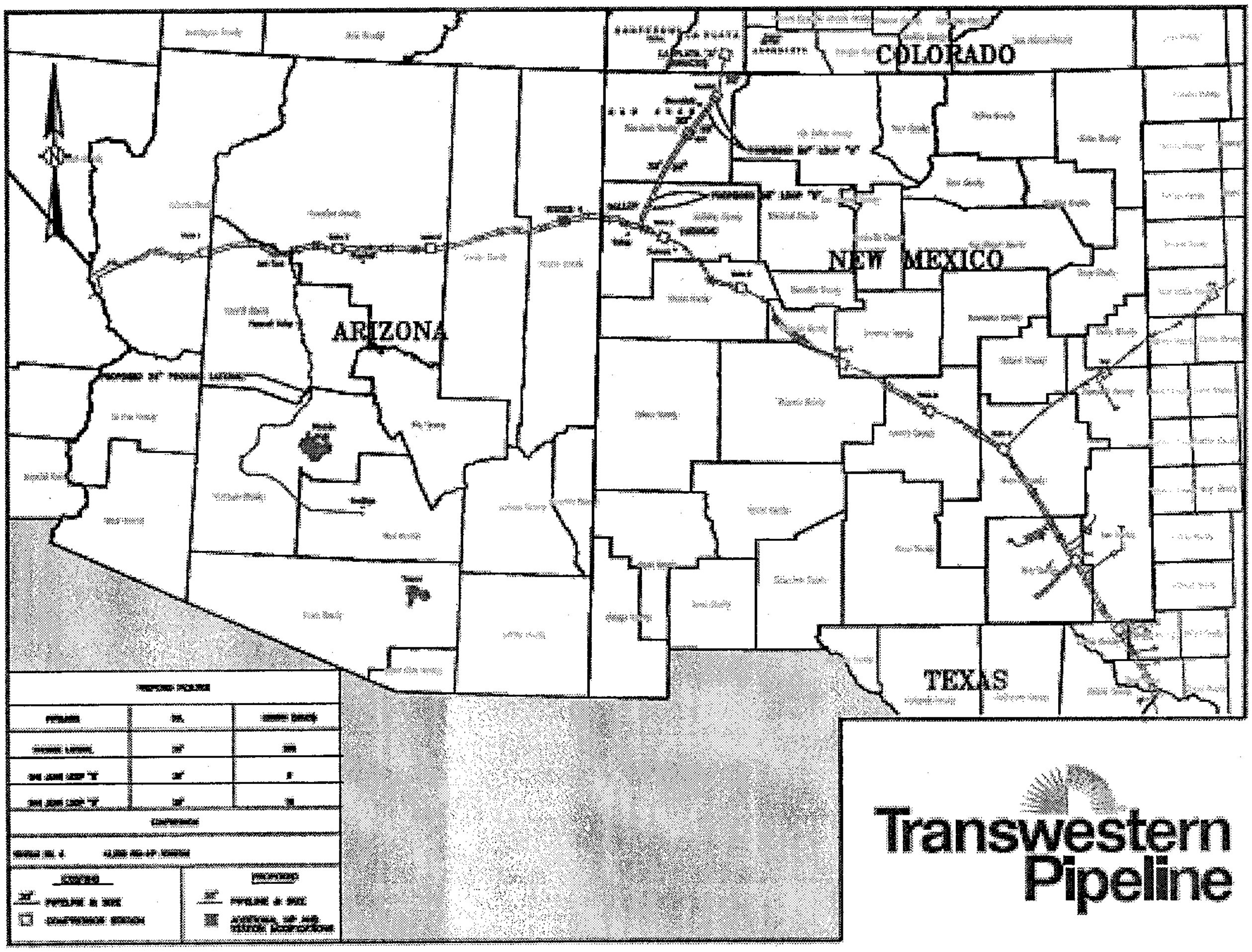
Introduction

On October 23, 2006, UNS Gas Inc. ("UNS" or "Company") filed for Commission pre-approval of cost recovery for participation in the Transwestern Pipeline Phoenix natural gas pipeline project ("Phoenix Expansion Project"). The Phoenix Expansion 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, passing through Yavapai County in the Prescott area. UNS' 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. UNS' application is the third request for pre-approval related to the Phoenix Expansion 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 Expansion Project (Decision No. 68597, March 23, 2006), subject to certain conditions. The Commission also previously approved an application by Southwest Gas for pre-approval of certain costs related to pipeline capacity on the Phoenix Expansion Project (Decision No. 68753, June 6, 2006). This Staff Report represents Staff's evaluation and recommendations regarding this UNS filing.

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



Source: Transwestern

Description of Phoenix Lateral Pipeline Project

The proposed Phoenix Expansion 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 in the Prescott area, skirting the Phoenix metro area to the west, and ending near Coolidge, Arizona. The Phoenix Expansion Project would have some ability to add additional capacity in the future if such growth is warranted. On September 15, 2006, Transwestern filed with the Federal Energy Regulatory Commission ("FERC") for a certificate of convenience and necessity to construct and operate the Phoenix Expansion Project in FERC Docket Number CP06-459. It is anticipated that the Phoenix Expansion Project will begin providing service in 2008.

Siting of the proposed Phoenix Expansion 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 UNS of costs related to the Phoenix Expansion 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 UNS, or other natural gas consumers such as electric generators or industrial customers. While UNS 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. UNS 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.

UNS' service territory covers a vast swath of northern Arizona and a smaller area in Santa Cruz County in southern Arizona. The northern Arizona area serves a number of communities, including Lake Havasu City, Kingman, Prescott, Sedona, Flagstaff, Camp Verde, and Show Low, while the southern Arizona territory includes the city of Nogales. UNS currently takes pipeline service from El Paso Natural Gas Company ("El Paso") for the southern Arizona service territory, as well as the majority of UNS' natural gas needs in northern Arizona. UNS currently takes some service from Transwestern in northern Arizona for Flagstaff and Kingman. UNS takes service from El Paso and Transwestern via a large number of taps on the respective pipeline systems, some of which are relatively small. This contrasts with electric generation entities in Arizona, which take interstate pipeline service at a small number of power plant locations.

Due to UNS' dispersed consumption of natural gas across many locations, it approaches a new interstate pipeline such as the Phoenix Expansion Project differently than do 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, such as UNS, have some ability to access supplies from different pipelines, but shippers in central and southern Arizona are at this time totally reliant on service from El Paso to meet their needs.

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 UNS. 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") recent 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 UNS, 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 liquid natural gas ("LNG") supplies into the California and/or Mexico markets in the near future. Most Arizona shippers, including much of UNS' consumption, 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. UNS already enjoys some diversity of this nature due to taking service from both El Paso and Transwestern.

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 some measure of potential pipeline competition for El Paso and would make it more difficult for El Paso to look to captive Arizona customers to cover costs it does not recover elsewhere.

In UNS' case, the Company has some amount of existing or potential flexibility in certain communities where both Transwestern and El Paso pipes are nearby, while other communities are served off of El Paso laterals, making it difficult if not impossible to source gas from a pipeline other than El Paso.

The specific area that would be impacted by UNS acquiring service off of the Phoenix Expansion Project would be the Prescott region in Yavapai County. Currently, the Prescott area is served by El Paso's Line 2204, which comes south through Chino Valley before entering Prescott. UNS' filing in this proceeding indicates that UNS would have three taps on the Phoenix Expansion Project, one on the east side of Chino Valley, and two in the Prescott Valley area. UNS has indicated that having a second major pipe running through the Prescott region would enhance service reliability in cases where there is an outage of some sort on one line. Additionally, UNS has indicated that the three taps have been located in areas where growth is expected and that taking service off of the Transwestern line running through those areas is likely to be less costly than expanding existing El Paso laterals or building new El Paso lines to serve such growth.

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 Liquid Natural Gas ("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, though difficult to quantify, 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 UNS 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 UNS' 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' contractual access to the San Juan basin was noticeably reduced. Arizona shippers do typically source cheaper San Juan gas supplies first, so Arizona shippers actual gas deliveries tend to be more heavily weighted to San Juan supplies than their contractual split between the San Juan and Permian basins would indicate. UNS has estimated that the Transwestern capacity would shift its gas supply mix from being 73 percent San Juan and 27 percent Permian to being 77 percent San Juan and 23 percent Permian. As discussed elsewhere, given that San Juan gas is typically cheaper, such a shift likely represents a savings to UNS on its commodity costs. UNS has indicated that absent this acquisition of San Juan-sourced Phoenix Expansion Project capacity, UNS would likely meet future growth needs via Permian-sourced capacity acquired from El Paso.

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 UNS. 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.

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 UNS' contract with Transwestern. For example, UNS 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 UNS over the next 15-year period. Regarding balancing, Transwestern would allow UNS to balance monthly with a 10 percent tolerance on its Phoenix Expansion Project capacity.

On December 6, 2006, a settlement agreement was filed with FERC in the on-going El Paso rate proceeding. Most parties to the El Paso rate case have expressed support for the settlement agreement. The ACC has identified itself as a non-opposing party, rather than a supporting party, due to certain concerns, particularly in regard to market structure issues.

Phelps Dodge is the only party that has identified itself as being in opposition to the proposed settlement agreement. At this time it is unknown whether FERC will approve the settlement or not, but the El Paso pipeline system has a long history of reaching FERC-approved settlements in its rate proceedings. As with any settlement agreement, it represents a variety of compromises on many issues. Shippers would receive some additional service flexibility under the settlement. Competitive issues discussed above are not really addressed in the settlement agreement, other than to set up a study group to look at rate design issues including the short-haul issue. The settlement agreement covers the period of 2006-2008, and would provide some certainty to operations on the El Paso system during that period. However, El Paso would file a new rate case in mid 2008, becoming effective, subject to refund, in January 2009. It is likely that the 2009 rate case would encompass a wide variety of major issues on the El Paso system, including many issues that have been disputed in the current rate case.

Description of the Phoenix Expansion Project Agreement Between UNS and Transwestern

The Phoenix Expansion Project agreement was entered into by UNS and Transwestern on September 14, 2006. A copy of the agreement was attached to UNS' application in this proceeding. 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 three delivery points are identified as being near Prescott South, Airport Station, and Chino Valley. Volumes vary by month, with UNS holding the largest monthly volumes during the winter months when it has the greatest demand. The monthly volumes, in dth, are shown in the table below.

Month	Prescott South	Airport Station	Chino Valley	Total dth/day
January	16,000	6,400	2,600	25,000
February	16,000	6,400	2,600	25,000
March	12,800	6,400	2,100	20,000
April	9,000	3,600	1,400	14,000
May	3,200	1,300	1,900	5,000
June	1,900	800	300	3,000
July	1,900	800	300	3,000
August	1,900	800	300	3,000
September	1,900	800	300	3,000
October	6,400	2,600	1,000	10,000
November	10,300	4,100	1,600	16,000
December	16,000	6,400	2,600	25,000

Annual average: 12,667 dth/day

The specific cost components for which UNS is seeking pre-approval of recovery are the reservation charge, volumetric rates, fuel rates, and applicable surcharges. For the reservation rate, the agreement reflects a fixed $0.415 per dth rate for receipt on the San Juan lateral and delivery at UNS' primary delivery points for the 15-year term of the agreement. The agreement contains provisions for UNS if it wishes to take receipt at other points, such as East-of-Thoreau, or take delivery at other points, such as downstream on the Phoenix Expansion Project.

The precedent agreement contains a variety of termination rights for both UNS and Transwestern if either party fails to take certain actions or meet certain criteria. Of note, one provision enables UNS to terminate the precedent agreement if "the Arizona Corporation Commission has not issued an order on or prior to March 1, 2007, authorizing the recovery by Shipper for ratemaking purposes of the costs to be incurred by Shipper under the Transportation Agreement." Staff believes that the March 1, 2007 deadline does not create any timing difficulties for processing UNS' application.

UNS Gas Pipeline Capacity and Natural Gas Demand

The table below lists UNS' current monthly pipeline capacity on the El Paso and Transwestern systems and lists the additional pipeline capacity UNS would acquire on the Phoenix Expansion project for comparison purposes.

Month (volumes in dth)	January	February	March	April	May	June
El Paso – northern system	48,648	47,965	52.287	24,227	15,973	16,344
El Paso – southern system	68,800	68,800	68,800	32,000	14,389	12,600
Existing Transwestern	25,000	25,000	25,000	15,000	10,000	10,000
Total Current Capacity	142,448	141,765	146,087	81,227	45,362	38,944
Phoenix Expansion Capacity	25,000	25,000	20,000	14,000	5,000	3,000
Total Capacity Post Phoenix Expansion	167,448	166,765	166,087	95,227	50,362	41,944
Month (volumes in dth)	July	August	September	October	November	December
El Paso – northern system	16,165	16,181	16,188	23,337	39,695	48,562
El Paso – southern system	12,807	12,762	12,718	14,623	32,569	68,800
Existing Transwestern	26,165	26,181	26,188	48,337	64,695	73,562
Total Current Capacity	38,972	38,943	38,906	62,960	97,264	142,362
Phoenix Expansion Capacity	3,000	3,000	3,000	10,000	16,000	25,000
Total Capacity Post Phoenix Expansion	41,972	41,943	41,906	72,960	113,264	167,362

UNS' contract with El Paso expires in 2011, providing the possibility that UNS could adjust its pipeline capacity portfolio as necessary to match its portfolio with its future needs.

UNS' projected peak day demands, which take place in December each year, are reflected in the following table.

Heating Season	Projected Peak Day Delivery (dth)
2006-2007	123,725
2007-2008	127,302
2008-2009	130,969
2009-2010	133,766
2010-2011	136,608
2011-2012	139,458
2012-2013	143,156
2013-2014	145,827
2014-2015	148,621

UNS' peak day demand projections reflect steady growth in the coming years, allowing UNS to grow into the additional capacity provided by the Phoenix Expansion Project. Any period of time in which UNS would not be fully utilizing the Transwestern capacity would likely be relatively short in duration, and UNS could likely minimize any excess capacity it would have during that short period of time through capacity release and other avenues. If UNS did not acquire capacity on the Phoenix Expansion Project, the Company would need to acquire additional capacity from another source in the coming years if demand grows as the Company expects.

Cost Analysis of Transwestern Service to UNS

UNS' filing contains a cost comparison between taking service on the Phoenix Expansion Project or taking service from El Paso. The analysis compares the pipeline charges under each option. The analysis also estimates the gas commodity cost difference of receiving San Juan basin gas via the Phoenix Expansion Project or Permian basin gas via El Paso. UNS' cost comparison reflects a reservation charge for Transwestern of $0.415 per dth, a fuel rate of 2.50 percent, and San Juan gas that is estimated to be $0.10 per dth cheaper than Permian gas. For El Paso service, UNS estimates a reservation charge of $0.4322 per dth (their initial proposal in their current rate proceeding), a fuel rate of 2.66 percent, and Permain gas that is estimated to be $0.10 per dth more expensive than San Juan gas. Under UNS' comparison, all three of these cost components are lower when taking service from the Phoenix Expansion Project in comparison to taking service from El Paso that is sourced in the Permian basin.

Under this cost comparison, it is clear that the Phoenix Expansion Project is less costly than taking comparable service that is expected to be available from El Paso. UNS estimates the total annual savings under the Phoenix Expansion Project option would be $631,456 in comparison to El Paso service, reflecting a savings of approximately $0.13 per dth of gas delivered.

UNS' application identifies further savings resulting from the month to month sculpting of its capacity on the Phoenix Expansion Project in comparison to the seasonal sculpting available on the El Paso system.

However, it is worth noting that the reservation rate reflected in the recently filed proposed settlement agreement in the El Paso rate case is less than the $0.4322 per dth rate used by UNS in its cost comparison. In the settlement agreement, the comparable rate is lower, $0.39 per dth. If this settlement rate is implemented by El Paso, upon FERC approval, then El Paso's reservation rate would be slightly lower than that available on the Phoenix Expansion, $0.39 versus $0.415. If UNS' cost comparison is adjusted to reflect this proposed settlement rate, previously cited $0.13 per dth cost differential shrinks to approximately $0.10 per dth. In this scenario, the slightly lower reservation rate on the El Paso system is outweighed by the lower fuel rate on the Transwestern, as well as the lower gas commodity cost of San Juan gas.

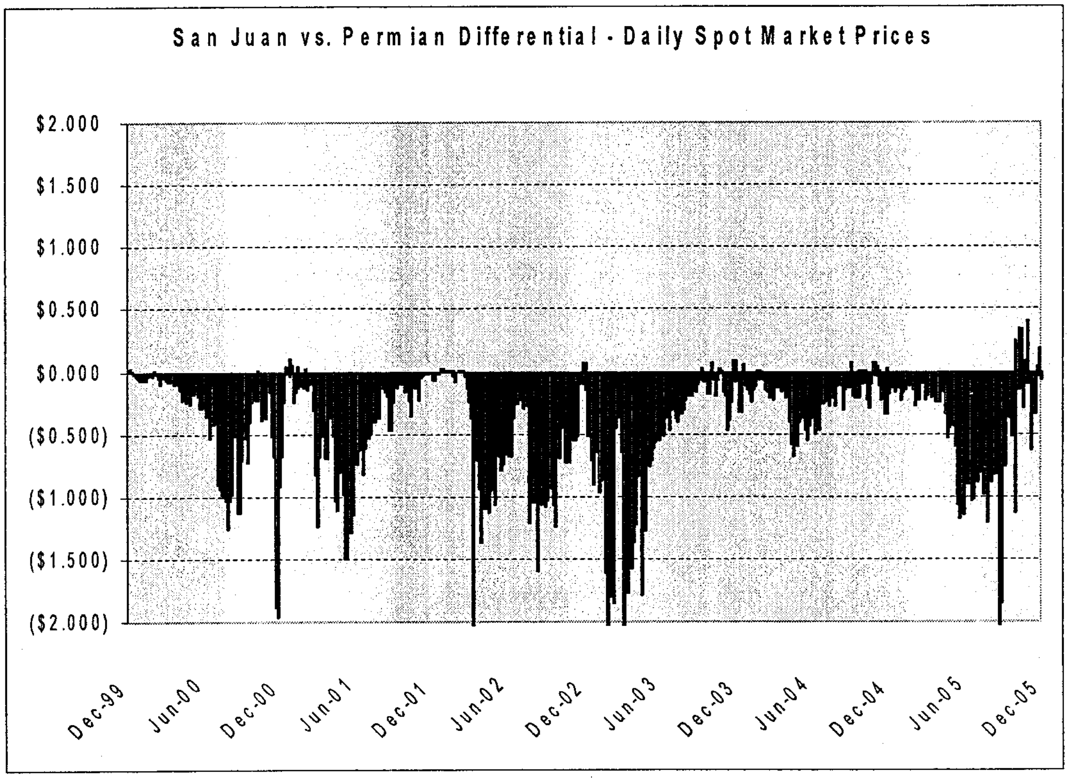
UNS has estimated that it will require several million dollars of additional facilities to interconnect with the Phoenix Expansion Project. However, if the Phoenix Expansion Project were not available to meet growing demand in the areas UNS expects it to serve, the costs of expanding existing El Paso line(s) or building new lines to these areas would likely be greater.

Regarding the price differential between San Juan and Permian gas supplies, UNS' use of a $0.10 per dth differential is relatively conservative given 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.

In summary, given the relative similarity and possibly slightly lower overall projected costs for UNS to take service from the Phoenix Expansion Project in comparison to El Paso service, intangible benefits, such as the introduction of pipeline competition into central Arizona, weigh heavily in deciding whether pre-approval is warranted in the proceeding.

UNS Method for Recovering Transwestern Costs

The Transwestern costs proposed for recovery are standard pipeline service related costs. UNS currently recovers its costs related to pipeline service from El Paso via its purchased gas adjustor ("PGA") mechanism. UNS' costs related to taking pipeline service from Transwestern should be recovered in the same manner, through the PGA mechanism. UNS would not incur costs for service on Transwestern until UNS would begin to take service from Transwestern, likely sometime in 2008 based upon current projections, so such costs would not likely begin to be passed along to UNS customers until 2008.

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 UNS' 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.

UNS' Application as Part of the Broader Scope of the Transwestern Project

UNS' share of pipeline capacity on the Transwestern project is relatively small in comparison to participation by some other Arizona entities. Given that Transwestern has actively moved forward with its certificate filing at FERC and taking other steps to construct the Phoenix Expansion Project, it does not appear that UNS' participation in the project or the Commission's pre-approval is of critical importance. However, UNS participation does expand the amount of capacity on the project which has been committed to by shippers, a factor FERC considers in its deliberations on new capacity additions. And if circumstances change and for some reason Transwestern might consider cancelling the Phoenix Expansion Project, a greater total level of shipper commitment is a positive factor that would make such a cancellation less likely.

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 APS and Southwest Gas filings for pre-approval of costs related to acquiring pipeline capacity on the Phoenix Expansion Project.

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

UNS' 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.

UNS 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 UNS 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 UNS begins taking service through the pipeline, currently projected to be in 2008. UNS 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 UNS' pipeline capacity rights, whether on the Transwestern pipeline or other pipelines. UNS still has a standing obligation to maximize the value of all its pipeline capacity assets for the benefit of the UNS ratepayers who pay for the capacity. So if the Commission in the future determined that UNS 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 UNS' present pipeline capacity.

It should be noted that even if the Commission provides pre-approval of UNS' 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.

UNS' 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 UNS' application conforms to the Commission's December 18, 2003 policy statement.

Section one of the policy statement addresses supply/infrastructure diversity. UNS' 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. UNS' participation in the Transwestern project does represent an effort to undertake long-term planning for UNS' 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 UNS' filing.

Section four of the policy statement addresses the general Commission approach. UNS' 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. UNS' application is reflective of the individual pipeline capacity and service needs of UNS 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. UNS has indicated a willingness to provide information to the Commission regarding its Transwestern capacity.

In summary, UNS' 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 UNS' Level of Risk

UNS, 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 UNS attempt to reduce the level of risk they face, as a reduced risk level is looked upon favorably for a variety of reasons. UNS' 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 UNS' acquisition of Transwestern capacity, it would seem to reduce UNS' risk in relation to this particular asset. The question of what this apparent reduction of risk means to UNS' overall level of risk is a more difficult question, as UNS faces a variety of different risks, both in its gas supply acquisition activities, and in various other segments of its business. UNS has indicated that it does not believe that Commission pre-approval of the acquisition of Transwestern capacity has a discernable impact on UNS' level of risk. Whether there is a discernable impact on UNS' risk and if so, what would be the proper treatment of the shift in risk are issues which are more properly considered in future UNS rate proceedings, when risk and other matters are considered in setting UNS' 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 UNS' risk be determined in a future rate proceeding.

Conclusions and Recommendations

UNS' acquisition of pipeline capacity on the Phoenix Expansion Project provides UNS with capacity to serve growth in the Prescott area at a cost that is projected to be lower than the otherwise available alternative from El Paso. While not a driving factor in the development of the Phoenix Expansion Project, UNS participation in the project expands the list of shippers who have committed to the project and increases the percentage of capacity contracted for on the new pipeline. The relatively favorable economics of UNS' participation in the Phoenix Expansion Project arguably weaken the need for the ACC to provide pre-approval to UNS for its acquisition of capacity. However, UNS is making a long-term commitment to capacity on a new pipeline project for which the ACC has already provided pre-approval to two other Arizona utilities, and

UNS participation would seem to be a positive factor in the Phoenix Expansion Project reaching fruition. Therefore, while Staff believes that pre-approval may not be as necessary in this case as some others the ACC has seen, Staff does support pre-approval of UNS' cost recovery of certain expenses related to its acquisition of pipeline capacity on the Phoenix Expansion Project.

UNS' 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 UNS, including potential reductions in future facility costs, 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 measure of rate and operational certainty. UNS' cost projections indicate that the Company expects that its participation in the Phoenix Expansion Project will reduce its gas cost in comparison to additional incremental service from El Paso over time both due to lower charges for pipeline service and from lower San Juan basin commodity costs. While there is some uncertainty regarding future costs, UNS' projections appear to be a reasonable estimation of what its costs may be in the coming years, for purposes of evaluating this pre-approval request.

Given the relative 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 for Commission pre-approval of cost recovery for UNS' participation in the Transwestern project as outlined in UNS' application and discussed herein. UNS' 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 UNS. 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 UNS' application reflects many of the same issues the Commission considered in approving APS' and Southwest's pre-approval applications in 2006.

Staff believes that UNS' participation in the Transwestern project is reasonable given the information available at this time. Staff recommends that the Commission pre-approve UNS' 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 UNS' 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 UNS' risk profile resulting from pre-approval of costs related to Transwestern pipeline capacity would be considered within the context of future UNS rate proceedings.

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

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

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

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

7. Pre-approval of the specific costs related to UNS' 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 UNS' ratepayers until all of the following occur:
   - The Transwestern pipeline is built and operational.
   - UNS is receiving service on the Transwestern project consistent with the precedent agreement and this order.

In summary, Staff recommends pre-approval of the cost-recovery for the specific pipeline capacity related costs UNS would incur on the Phoenix Expansion Project as discussed herein, subject to the conditions above.

BEFORE THE ARIZONA CORPORATION COMMISSION

JEFF HATCH-MILLER
Chairman
WILLIAM A. MUNDELL
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner
GARY PIERCE
Commissioner

IN THE MATTER OF THE APPLICATION OF UNS GAS INC. FOR PRE-APPROVAL OF COST RECOVERY FOR THE ACQUISITION OF PIPELINE CAPACITY ON THE TRANSWESTERN PHOENIX EXPANSION PROJECT.	DOCKET NO. G-04204A-06-0627 DECISION NO. ___________ ORDER

Open Meeting
February 13 and 14, 2007
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. UNS Gas Inc. ("UNS") is engaged in providing natural gas service within portions of Arizona, pursuant to authority granted by the Arizona Corporation Commission ("Commission").

2. On October 23, 2006, UNS filed for Commission pre-approval of cost recovery for participation in the Transwestern Pipeline's ("Transwestern") Phoenix Expansion Project ("Project").

3. The Project is a new project which Transwestern would undertake, comprising a combination of some existing pipeline capacity in some segments, and some new construction. The Project would provide additional access to San Juan basin natural gas to shippers, including UNS. The Project would run through Yavapai County, where UNS would take service via three

. . .

taps in the Prescott area. The Project would then skirt the western side of the Phoenix metro area before entering Pinal County and ending near Coolidge, Arizona.

4. On January 30, 2007, Staff filed its Staff Report in this matter, containing Staff's evaluation and recommendations regarding the Southwest filing.

5. UNS currently receives interstate pipeline service from both El Paso Natural Gas Company ("El Paso") and Transwestern. UNS receives service from El Paso in Santa Cruz County and in many locations in northern Arizona, including the Prescott area. UNS currently receives service from Transwestern in the Flagstaff and Kingman areas.

6. UNS' service on El Paso has changed significantly in recent years, including the conversion from full requirements to contract demand rights in 2003 and the introduction of new service, penalty, and other operational provisions in the current rate case proceeding before the Federal Energy Regulatory Commission ("FERC"). On December 6, 2006, a proposed settlement agreement was filed with FERC in the El Paso rate case.

7. Under UNS' precedent agreement with Transwestern, UNS would take monthly sculpted service on the Project at the Prescott South, Airport Station, and Chino Valley delivery points. The precedent agreement reflects a 15-year term, during which UNS would pay a fixed $0.415 per decatherm ("dth") reservation charge for receipt of natural gas in the San Juan basin for delivery in the Prescott area.

8. Introduction of some level of pipeline competition into central Arizona via the Project would diversify Arizona's natural gas infrastructure, would provide some shippers and delivery points with a competitive option, would provide additional access to historically cheaper San Juan supply basin natural gas, and could lead to the creation of a market center for natural gas pricing in Arizona. Additionally, UNS has indicated that introduction of the Project to the Prescott area would enhance service reliability and would reduce the cost of future capital costs for infrastructure in the area.

9. UNS' application contains a cost comparison that indicates that UNS expects that it would save on both pipeline service costs and commodity costs by taking service from Transwestern on the Project rather than acquiring additional Permian supply basin sourced pipeline

capacity from El Paso. Proposed rates in the El Paso rate case settlement agreement before FERC are lower than those contained in UNS' initial cost comparison, but even with the lower proposed El Paso settlement rates, service on the Project for UNS is projected to be less costly.

10. The Staff Report discusses a variety of issues related to UNS' application in greater detail.

11. UNS states in its application that its filing is pursuant to the Commission's December 18, 2003 Policy Statement Regarding New Natural Gas Pipeline and Storage Costs, which encourages development of needed natural gas infrastructure in Arizona.

12. The Staff Report recommends adoption of the following conditions:

- The Commission retains full authority to review UNS' 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.
- The impact, if any, on UNS' risk profile resulting from pre-approval of costs related to Transwestern pipeline capacity would be considered within the context of future UNS rate proceedings.
- UNS shall file a status report on the Transwestern project and UNS' participation in the project with the Commission every six months until either UNS begins taking service from Transwestern or UNS' participation in the project is terminated.
- UNS shall file a notice with the Commission within ten days of when the exact volumetric and fuel rates, applicable for UNS when UNS begins service with Transwestern, are set for the Transwestern pipeline.
- UNS shall file a notice with the Commission within ten days of each of the following events regarding the Transwestern project: a) FERC granting approval of the pipeline, b) Transwestern beginning construction of the pipeline, c) Transwestern completing construction of the pipeline, and d) UNS beginning to take service from the Transwestern pipeline.

- UNS shall file a notice with the Commission if at any time either UNS or Transwestern exercises termination rights pursuant to the precedent agreement or if any other events significantly impact UNS' participation in the Transwestern project, within ten days of any such action.
- Pre-approval of the specific costs related to UNS' 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.
- None of the pre-approved costs will be passed on to UNS' ratepayers until all of the following occur:

  A. The Transwestern pipeline is built and operational.

  B. UNS is receiving service on the Transwestern project consistent with the precedent agreement and this order.

13. Staff believes that UNS' participation in the Project is reasonable given the information available at this time.

14. Staff has recommended that the Commission pre-approve cost recovery of UNS' specific costs related to the Project at issue in this proceeding, including the reservation charges, volumetric charges, fuel charges, and applicable surcharges, subject to certain conditions.

CONCLUSIONS OF LAW

1. UNS is an Arizona public service corporation with the meaning of Article XV, Section 2, of the Arizona Constitution.

2. The Commission has jurisdiction over UNS and over the subject matter of this application.

3. The Commission, having reviewed the application and Staff's Memorandum and attached Staff Report dated January 30, 2007, concludes that it is in the public interest to approve

the request for pre-approval of cost recovery of reservation charges, volumetric charges, fuel charges, and applicable surcharges, subject to certain conditions.

ORDER

IT IS THEREFORE ORDERED that UNS' cost recovery of reservation charges, volumetric charges, fuel charges, and applicable surcharges related to the Phoenix Expansion Project pipeline capacity at issue in this proceeding be and hereby is pre-approved, subject to conditions identified in Finding of Fact Number 12.

IT IS FURTHER ORDERED that this Order shall be effective immediately.

BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this _______day of ____________________, 2007.

____

BRIAN C. McNEIL
Executive Director

DISSENT: ____________________________

DISSENT: ____________________________

EGJ:RGG:tdp/JMA

SERVICE LIST FOR: UNS Gas, Inc.
DOCKET NO. G-04204A-06-0627

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