ORIGINAL

OPEN MEETING

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MEMORANDUM

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Arizona Corporation Commission
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AZ CORP COMMISSION
DOCKET CONTROL

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TO: THE COMMISSION

FROM: Utilities Division

DATE: January 30, 2008

RE: IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR COMMISSION APPROVAL OF PROPOSED SALES AND TRANSPORTATION AGREEMENTS BETWEEN UNS GAS AND UNISOURCE ENERGY DEVELOPMENT COMPANY (DOCKET NOS. G-04204A-07-0696 AND E-04230A-07-0696)

I. Introduction

On December 18, 2007, UNS Gas, Inc. ("UNS Gas") filed for Commission approval of proposed sales and transportation agreements ("the Agreements") between UNS Gas and Unisource Energy Development Company ("UED'). Staff and UNS Gas held a number of discussions regarding the Agreements. On January 29, 2008, UNS Gas made a filing, revising the proposed transportation agreement to reflect a five year true-up of the allocation factor between UNS Gas and UED and a monthly customer charge. Following is Staff's analysis and recommendations on the Agreements.

II. Discussion

UED is an unregulated affiliate of UNS Gas, under the parent company Unisource Energy Corporation. UED is constructing a 90 megawatt simple cycle gas-fired electric generation station, known as the Black Mountain Generating Station ("BMGS"), near Kingman, Arizona. UED's intention is to sell the BMGS to UNS Electric. UNS Electric is seeking extraordinary rate treatment of BMGS as part of its current general rate proceeding in Docket No. E-04204A-06-0783. The Agreements contain provisions allowing UED to assign or transfer these agreements to another party. To the extent that UED is successful in the sale of the BMGS to UNS Electric, UNS Electric would become the successor in interest of UED in these Agreements. As long term transactions between two affiliated entities with the Unisource family of companies, a greater level of scrutiny is required than if these were agreements between two unaffiliated entities. UNS Gas has indicated to Staff that any modification or extension of these Agreements, other than the contemplated assignment of the Agreements, will be brought to the Commission for approval. UNS Gas has indicated it will hold UED to the same creditworthiness requirements to which it holds other comparable customers. UNS Gas has indicated it expects to begin flowing test gas to the BMGS in March 2008 and that the BMGS will begin operation in May 2008. UNS Gas has provided certain pricing provisions of these Agreements to Staff under the terms of a confidentiality agreement.

The proposed transportation agreement involves the terms of service for flowing gas to the BMGS facility over the newly constructed distribution pipeline. UNS Gas has built a 16-inch distribution line from its interconnection with the Transwestern Pipeline interstate system to serve BMGS as well as some retail customers in the area. An example of a possible new retail customer for UNS Gas is the Kingman Prison, which currently uses propane and could benefit from taking natural gas service from UNS Gas. UNS Gas anticipates flowing test gas over the new distribution line in March 2008. The transportation agreement addresses the costs of constructing and operating this new distribution line and the allocation of those costs between UNS Gas core customers and UED. The transportation agreement is for a 20 year term, beginning with the date natural gas begins to flow to the BMGS. The estimated capital cost of the pipeline is $5,782,245. UNS Gas' initial allocation of costs between UED and UNS Gas core customers was based on a calculation of the cost of building a 6-inch distribution line to serve the core customers and then assigning the remaining cost to UED. Under this allocation method, UED would initially be responsible for $4,739,383 or approximately 82 percent of the capital costs, with core customers initially being assigned $1,042,862 or approximately 18 percent of capital costs.

The costs assigned to UED factor into the monthly transportation charge assessed by UNS Gas to UED under the transportation agreement. The costs assigned to core customers will not be recovered by UNS Gas until it receives authorization from the Commission in future rate proceedings. Any capital costs initially allocated to core customers but not recovered from new core customers through new customer connections would be reassigned to UED after a five year period. Staff has some concern with the allocation method used by UNS Gas, in that UNS Gas core customers may have more costs assigned to them than is warranted given they are assigned all costs related to what a six-inch distribution line would cost, when in fact they are simply an extra increment of service on a larger 16-inch distribution line. However, given the Commission's ability to review all costs in future rate cases for reasonableness and prudency before they are charged to UNS Gas core customers, Staff recommends that the Commission not decide this allocation issue in the instant case, but do so in a future rate case. For the limited purpose of UNS Gas setting initial rates in the transportation agreement, UNS Gas may use the initial allocation. Staff is proposing a requirement that in upcoming UNS Gas rate cases, that UNS Gas specifically document the costs and related information regarding new core customers who take service off of this distribution line. UNS Gas' updated filing includes a monthly customer charge to UED equal to the currently effective customer charge for large volume pricing plan customers. Inclusion of this customer charge is comparable to UNS Gas' treatment of Negotiated Sales Program ("NSP") customers on this issue.

The proposed sales agreement between UNS Gas and UED would involve UNS Gas acting as an agent for UED in acquiring natural gas supplies and interstate pipeline transportation service for the BMGS facility. This in many ways is comparable to the customers UNS Gas serves under its NSP. UNS Gas currently acquires its natural gas supplies under a gas supply arrangement with British Petroleum ("BP"). UNS Gas has indicated to Staff that UED will be treated in a similar manner regarding gas supply acquisition in the future, whether the BP agreement continues or UNS Gas terminates the BP agreement and conducts all supply acquisition activities itself. The sales agreement has a 20 year initial term. As with the transportation agreement, UNS Gas states that it will file for Commission approval if the agreement is extended beyond the initial 20 year term, or is modified beyond modifications allowed under the agreement.

As part of the sales agreement, UNS Gas has acquired some pipeline capacity from Transwestern to serve UED. The volume of capacity acquired by UNS Gas to serve UED is less than the total requirements of the BMGS if it is running at full capacity. For this first block of capacity acquired from Transwestern to serve UED, UED will repay UNS Gas for all costs related to acquiring this capacity for UED. For UED pipeline capacity needs above this first block of capacity, UNS Gas would either use spare capacity it has, or acquire capacity for UED in the capacity release market. Additionally, to the extent UED is not using the first block of capacity, this capacity could be available for UNS Gas to use. To the extent UED uses capacity paid for by UNS Gas, or UNS Gas uses capacity paid for by UED, the party initially owning the capacity would be compensated by the party using the capacity. The possible flexibility provided by the potential availability of this capacity to both entities is a benefit to both entities. The extent to which pipeline capacity will be transferred between the two entities is unclear at this time and will depend upon a variety of factors, including the need for pipeline capacity by each of the entities, as well as circumstances on the upstream pipelines. Staff is recommending that UNS Gas include a new page in its monthly PGA reports filed with the Commission, documenting all transfers of capacity between UNS Gas and UED. Inclusion of this information in the monthly PGA reports will provide the Commission with on-going and readily available information on the nature and extent of capacity transfers between UNS Gas and UED.

Typically when UNS Gas enters into a sales agreement like this, in most cases such agreements being with NSP customers, there is a 50/50 sharing of the margin provided by payments from the customer to UNS Gas for use of its pipeline capacity. The 50/50 sharing means that 50 percent of the margin goes to UNS Gas core customers via the Purchased Gas Adjustor ("PGA") mechanism, with 50 percent going to Unisource shareholders. This sharing level was established for NSP agreements in Decision No. 59399 (November 28, 1995). UNS Gas currently has 14 NSP customers for whom the 50/50 split applies. UNS Gas' initial filing did not identify a specific sharing split. In subsequent discussions with Staff, UNS Gas indicated its expectation was to apply the 50/50 split as it does for NSP customers.

The most recent case where the issue of splitting revenues between core customers and shareholders on the UNS Gas system took place was when the system was still owned by Citizens Utilities Company ("Citizens") and involved the sharing of a payment from Questar's Southern Trails Pipeline to Citizens for a potential reduction in pipeline capacity on the lateral serving the Griffith generating station near Kingman, Arizona. In that case, the Commission ruled in Decision No. 65214 (September 20, 2002) that the payment from Questar should be split in a 75/25 split, with core customers receiving 75 percent of the payment, and Citizens' shareholders receiving 25 percent.

Staff believes that circumstances have changed significantly since the 1994 decision implementing the 50/50 split. At that time, Citizens was still a full requirements customer on the El Paso pipeline system, and thus, between El Paso rate cases, there was very little incremental cost to Citizens' core customers to serve new incremental loads such as a new power plant would represent. By contrast, today full requirements service is no longer available to UNS Gas, and UNS Gas core customers pay the full tariffed pipeline reservation rate for pipeline capacity that would then in certain circumstances be used to serve UED, if UNS Gas did not need the pipeline capacity. Thus, UNS Gas core customers have significantly greater cost exposure today than they did at the time the Commission approved the 50/50 split for NSP customer agreements. Further, the Commission's 1994 Decision allowing the 50/50 split identified the risk to Citizens of experiencing exposure to a loss as a result of these agreements as a factor. In a circumstance like this proceeding, where the agreements are between two affiliated entities within Unisource, it does not appear that UNS Gas would be experiencing exposure to losses as a result of this agreement. Thus, Staff believes that in this matter 75/25 sharing percent of the margin should be credited to UNS Gas core customers.

III. Recommendations

Staff recommends approval of the transportation and sales agreements between UNS Gas and UED, subject to the conditions identified below.

Staff further recommends that the Agreements be modified to state that any assignment to UNS Electric or other entity will be subject to Commission review and approval, and may result in changes to the Agreements' terms and conditions as deemed necessary by the Commission in future dockets or related dockets now pending before the Commission.

Staff further recommends that UNS Gas, in any rate case filed in the next five years, and in the first rate case filed after the next five years, provide testimony and exhibits documenting any new UNS Gas customers, and related distribution costs, on this new distribution line, UNS is seeking to recover in the rate proceeding.

Staff further recommends that UNS Gas make a filing with Docket Control in this docket whenever the allocation of capital costs between UNS Gas and UED, or any successor companies is changed, within 10 days of the effective date of the new allocation.

Staff further recommends that UNS Gas file a summary report with Docket Control in this docket, within 30 days of this agreement having been in place for five years, when UNS Gas conducts its five-year true-up and possible reallocation of unrecovered capital costs to UED, or any successor corporation. This summary report should identify new customers and associated capital costs allocated to UNS Gas, any unrecovered capital costs that are reallocated to UED, or its successor companies, and the resulting allocation factors for UNS Gas and UED, or any successor companies.

Staff further recommends that UNS Gas include a new page in its monthly PGA report that is filed with the Commission, documenting any pipeline capacity transactions under the sales agreement between UNS Gas and UED, or its successor corporation, identifying volumes of capacity, associated payments, supply basin(s) where capacity originates, and date(s) capacity was exchanged.

Staff further recommends that under the sales agreement the margin split between UNS Gas core customers and Unisource shareholders be set at 75/25 split with 75 percent going to the core customers.

Staff further recommends that UNS Gas file a letter with Docket Control in this docket, indicating the date when it begins flowing test gas to the BMGS, and thus identifying the date when these contracts would formally begin.

Ernest G. Johnson
for Director
Utilities Division

EGJ:RGG:lhm\KL

ORIGINATOR: Robert Gray

BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR COMMISSION APPROVAL OF PROPOSED SALES AND TRANSPORTATION AGREEMENTS BETWEEN UNS GAS AND UNISOURCE ENERGY DEVELOPMENT COMPANY

DOCKET NOS. G-04204A-07-0696
E-04230A-07-0696

DECISION NO. ___________

ORDER

Open Meeting
February 12 and 13, 2008
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

I. Introduction

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

2. On December 18, 2007, UNS Gas filed for Commission approval of proposed sales and transportation agreements ("the Agreements") between UNS Gas and Unisource Energy Development Company ("UED").

3. Staff and UNS Gas held a number of discussions regarding the Agreements.

4. On January 29, 2008, UNS Gas made a filing, revising the proposed transportation agreement to reflect a five year true-up of the allocation factor between UNS Gas and UED and a monthly customer charge. Following is Staff's analysis and recommendations on the Agreements.

II. Discussion

5. UED is an unregulated affiliate of UNS Gas, under the parent company Unisource Energy Corporation. UED is constructing a 90 megawatt simple cycle gas-fired electric generation station, known as the Black Mountain Generating Station ("BMGS"), near Kingman, Arizona.

6. UED's intention is to sell the BMGS to UNS Electric. UNS Electric is seeking extraordinary rate treatment of BMGS as part of its current general rate proceeding in Docket No. E-04204A-06-0783. The Agreements contain provisions allowing UED to assign or transfer these agreements to another party. To the extent that UED is successful in the sale of the BMGS to UNS Electric, UNS Electric would become the successor in interest of UED in these Agreements.

7. As long term transactions between two affiliated entities with the Unisource family of companies, a greater level of scrutiny is required than if these were Agreements between two unaffiliated entities. UNS Gas has indicated to Staff that any modification or extension of these Agreements, other than the contemplated assignment of the Agreements, will be brought to the Commission for approval.

8. UNS Gas has indicated it will hold UED to the same creditworthiness requirements to which it holds other comparable customers. UNS Gas has indicated it expects to begin flowing test gas to the BMGS in March 2008 and that the BMGS will begin operation in May 2008.

9. UNS Gas has provided certain pricing provisions of these Agreements to Staff under the terms of a confidentiality agreement.

10. The proposed transportation agreement involves the terms of service for flowing gas to the BMGS facility over the newly constructed distribution pipeline. UNS Gas has built a 16-inch distribution line from its interconnection with the Transwestern Pipeline interstate system to serve BMGS as well as some retail customers in the area. An example of a possible new retail customer for UNS Gas is the Kingman Prison, which currently uses propane and could benefit from taking natural gas service from UNS Gas. UNS Gas anticipates flowing test gas over the new distribution line in March 2008.

. . .

11. The transportation agreement addresses the costs of constructing and operating this new distribution line and the allocation of those costs between UNS Gas core customers and UED.

12. The transportation agreement is for a 20 year term, beginning with the date natural gas begins to flow to the BMGS.

13. The estimated capital cost of the pipeline is $5,782,245. UNS Gas' initial allocation of costs between UED and UNS Gas core customers was based on a calculation of the cost of building a 6-inch distribution line to serve the core customers and then assigning the remaining cost to UED. Under this allocation method, UED would initially be responsible for $4,739,383 or approximately 82 percent of the capital costs, with core customers initially being assigned $1,042,862 or approximately 18 percent of capital costs.

14. The costs assigned to UED factor into the monthly transportation charge assessed by UNS Gas to UED under the transportation agreement.

15. The costs assigned to core customers will not be recovered by UNS Gas until it receives authorization from the Commission in future rate proceedings. Any capital costs initially allocated to core customers but not recovered from new core customers through new customer connections would be reassigned to UED after a five year period.

16. Staff has some concern with the allocation method used by UNS Gas, in that UNS Gas core customers may have more costs assigned to them than is warranted given they are assigned all costs related to what a six-inch distribution line would cost, when in fact they are simply an extra increment of service on a larger 16-inch distribution line. However, given the Commission's ability to review all costs in future rate cases for reasonableness and prudency before they are charged to UNS Gas core customers, Staff recommends that the Commission not decide the allocation issue until a future rate case. For the limited purpose of UNS Gas setting initial rates in the transportation agreement, UNS Gas may use the initial allocation.

17. Staff is proposing a requirement that in upcoming UNS Gas rate cases, that UNS Gas specifically document the costs and related information regarding new core customers who take service off of this distribution line.

. . .

18. UNS Gas' updated filing includes a monthly customer charge to UED equal to the currently effective customer charge for large volume pricing plan customers. Inclusion of this customer charge is comparable to UNS Gas' treatment of Negotiated Sales Program ("NSP") customers on this issue.

19. The proposed sales agreement between UNS Gas and UED would involve UNS Gas acting as an agent for UED in acquiring natural gas supplies and interstate pipeline transportation service for the BMGS facility. This in many ways is comparable to the customers UNS Gas serves under its NSP.

20. UNS Gas currently acquires its natural gas supplies under a gas supply arrangement with British Petroleum ("BP"). UNS Gas has indicated to Staff that UED will be treated in a similar manner regarding gas supply acquisition in the future, whether the BP agreement continues or UNS Gas terminates the BP agreement and conducts all supply acquisition activities itself.

21. The sales agreement has a 20 year initial term. As with the transportation agreement, UNS Gas stated that it will file for Commission approval if the agreement is extended beyond the initial 20 year term, or is modified beyond modifications allowed under the agreement.

22. As part of the sales agreement, UNS Gas has acquired some pipeline capacity from Transwestern to serve UED. The volume of capacity acquired by UNS Gas to serve UED is less than the total requirements of the BMGS if it is running at full capacity. For this first block of capacity acquired from Transwestern to serve UED, UED will repay UNS Gas for all costs related to acquiring this capacity for UED.

23. For UED pipeline capacity needs above this first block of capacity, UNS Gas would either use spare capacity it has, or acquire capacity for UED in the capacity release market. Additionally, to the extent UED is not using the first block of capacity, this capacity could be available for UNS Gas to use. To the extent UED uses capacity paid for by UNS Gas, or UNS Gas uses capacity paid for by UED, the party initially owning the capacity would be compensated by the party using the capacity.

24. The possible flexibility provided by the potential availability of this capacity to both entities is a benefit to both entities. The extent to which pipeline capacity will be transferred

between the two entities is unclear at this time and will depend upon a variety of factors, including . . . the need for pipeline capacity by each of the entities, as well as circumstances on the upstream pipelines.

25. Staff is recommending that UNS Gas include a new page in its monthly PGA reports filed with the Commission, documenting all transfers of capacity between UNS Gas and UED. Inclusion of this information in the monthly PGA reports will provide the Commission with on-going and readily available information on the nature and extent of capacity transfers between UNS Gas and UED.

26. Typically when UNS Gas enters into a sales agreement like this, in most cases such agreements being with NSP customers, there is a 50/50 sharing of the margin provided by payments from the customer to UNS Gas for use of its pipeline capacity. The 50/50 sharing means that 50 percent of the margin goes to UNS Gas core customers via the Purchased Gas Adjustor ("PGA") mechanism, with 50 percent going to Unisource shareholders.

27. This sharing level was established for NSP agreements in Decision No. 59399 (November 28, 1995). UNS Gas currently has 14 NSP customers for whom the 50/50 split applies. UNS Gas' initial filing did not identify a specific sharing split. In subsequent discussions with Staff, UNS Gas indicated its expectation was to apply the 50/50 split as it does for NSP customers.

28. The most recent case where the issue of splitting revenues between core customers and shareholders on the UNS Gas system took place was when the system was still owned by Citizens Utilities Company ("Citizens") and involved the sharing of a payment from Questar's Southern Trails Pipeline to Citizens for a potential reduction in pipeline capacity on the lateral serving the Griffith generating station near Kingman, Arizona. In that case the Commission ruled in Decision No. 65214 (September 20, 2002) that the payment from Questar should be split in a 75/25 split, with core customers receiving 75 percent of the payment, and Citizens' shareholders receiving 25 percent.

29. Staff believes that circumstances have changed significantly since the 1994 decision implementing the 50/50 split. At that time, Citizens was still a full requirements customer on the El Paso pipeline system, and thus, between El Paso rate cases, there was very little incremental cost to Citizens' core customers to serve new incremental loads such as a new power plant would represent.

30. By contrast, today full requirements service is no longer available to UNS Gas, and UNS Gas core customers pay the full tariffed pipeline reservation rate for pipeline capacity that would then in certain circumstances be used to serve UED, if UNS Gas did not need the pipeline capacity. Thus, UNS Gas core customers have significantly greater cost exposure today than they did at the time the Commission approved the 50/50 split for NSP customer agreements.

31. Further, the Commission's 1994 Decision allowing the 50/50 split identified the risk to Citizens of experiencing exposure to a loss as a result of these agreements as a factor. In a circumstance like this proceeding, where the agreements are between two affiliated entities within Unisource, it does not appear that UNS Gas would be experiencing exposure to losses as a result of this agreement.

32. Thus, Staff believes that in this matter 75 percent of the margin should be credited to UNS Gas core customers.

III. Recommendations

33. Staff has recommended approval of the transportation and sales agreements between UNS Gas and UED, subject to the conditions identified below.

34. Staff has further recommended that the Agreements be modified to state that any assignment to UNS Electric or other entity will be subject to Commission review and approval, and may result in changes to the Agreements' terms and conditions as deemed necessary by the Commission in future dockets or related dockets now pending before the Commission.

35. Staff has further recommended that UNS Gas, in any rate case filed in the next five years, and in the first rate case filed after the next five years, provide testimony and exhibits documenting any new UNS Gas customers, and related distribution costs, on this new distribution line, UNS is seeking to recover in the rate proceeding.

36. Staff has further recommended that UNS Gas make a filing with Docket Control in this docket whenever the allocation of capital costs between UNS Gas and UED, or any successor companies is changed, within 10 days of the effective date of the new allocation.

37. Staff has further recommended that UNS Gas file a summary report with Docket Control in this docket, within 30 days of this agreement having been in place for five years, when UNS Gas conducts its five-year true-up and possible reallocation of unrecovered capital costs to UED, or any successor companies. This summary report should identify new customers and associated capital costs allocated to UNS Gas, any unrecovered capital costs that are reallocated to UED, or any successor companies, and the resulting allocation factors for UNS Gas and UED, or any successor companies.

38. Staff has further recommended that UNS Gas include a new page in its monthly PGA report that is filed with the Commission, documenting any pipeline capacity transactions under the sales agreement between UNS Gas and UED, or its successor companies, identifying volumes of capacity, associated payments, supply basin(s) where capacity originates, and date(s) capacity was exchanged.

39. Staff has further recommended that under the sales agreement the margin split between UNS Gas core customers and Unisource shareholders be set at a 75/25 split with 75 percent going to the core customers.

40. Staff has further recommended that UNS Gas file a letter with Docket Control in this docket, indicating the date when it begins flowing test gas to the BMGS, and thus identifying the date when these contracts would formally begin.

CONCLUSIONS OF LAW

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

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

. . .

. . .

3. The Commission, having reviewed the application and Staff's Memorandum dated January 30, 2008, concludes that it is in the public interest to approve the sales and transportation agreements between UNS Gas and UED, subject to the provisions of Findings of Fact Nos. 33-40.

ORDER

IT IS THEREFORE ORDERED that the sales and transportation agreements between UNS Gas and UED, subject to the conditions in Findings of Fact Nos. 33-40, be and hereby are approved.

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 DEAN S. MILLER, Interim 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 ___________________, 2008.

DEAN S. MILLER
Interim Executive Director

DISSENT: ____________________________

DISSENT: ____________________________

EGJ:RGG:lhm\KL

SERVICE LIST FOR: UNS Gas, Inc.
DOCKET NOS. G-04204A-07-0696, E-04230A-07-0696

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