LE
RC
LLP
LAWYERS

0000114675

ORIGINAL

ı Office
ɔuth Church Avenue
'00
ı, Arizona 85701-1611
ıile (520) 622-3088
Telephone (520) 622-2090

Las Vegas Office
3993 Howard Hughes Parkway
Suite 600
Las Vegas, Nevada 89109
Facsimile (702) 949-8398
Telephone (702) 949-8200

Thomas H. Campbell
Direct Dial: (602) 262-5723
Direct Fax: (602) 734-3841
Internet: TCampbell@lrlaw.com
Admitted in Arizona

RECEIVED
2002 DEC 31 P 2: 23
AZ CORP COMMISSION
DOCUMENT CONTROL

Our File Number 38655-00008

December 31, 2002

HAND DELIVERED

Arizona Corporation Commission
DOCKETED
DEC 31 2002
DOCKETED BY CAC

Arizona Corporation Commission
Utilities Division – Docket Control
1200 W. Washington Street
Phoenix, Arizona 85008

Re: Duke Energy Arlington Valley L.L.C. CEC Application
Docket No: L-00000P-01-0117

Pursuant to Condition No. 15 in Arizona Corporation Commission Decision No. 64717, Duke is filing the enclosed report on the December 11, 2002 gas transportation workshop.

Very truly yours,

LEWIS AND ROCA LLP

Tom Campbell

Thomas H. Campbell

THC/bjg
Enclosure

cc: Laurie Woodall (w/enc.)
Janice Alward (w/enc.)
Patrick Williams (w/enc.)

REPORT ON WORKSHOP ON ARIZONA NATURAL GAS TRANSPORTATION RELIABILITY AND CAPACITY

December 11, 2002
Wigwam Resort
Phoenix, Arizona

REPORT ON ARIZONA WORKSHOP ON NATURAL GAS TRANSPORTATION RELIABILITY AND CAPACITY
December 11, 2002

Pursuant to Arizona Corporation Commission (ACC) Decision No. 64495, as amended in ACC Decision No. 64717, a workshop was held to discuss natural gas transportation reliability and capacity issues in the State of Arizona (Workshop). Over forty individuals attended the December 11th Workshop, including representatives from the Arizona Corporation Commission, Duke Energy North America, Salt River Project, Pinnacle West Capital Corporation, Arizona Public Service, Southwest Gas Corporation, South Western Power Group, Mesquite Power, Desert Energy, Harquahala Generating Company, Allegheny Energy Supply, and several consulting groups. *See* attached attendance roster. Tom Campbell of Lewis and Roca acted as moderator.

The two-part Workshop focused upon the capacity and reliability of the gas supply transportation system serving Arizona. Part One of the Workshop consisted of several presentations that are summarized below. Part Two entailed an open discussion with all attendees reacting to the presentations and identifying relevant issues to be considered. Parts Three and Four summarize conclusions from the Workshop and also schedule future workshops on the topics.

PART I. SPEAKER PRESENTATIONS.

1. **Greg Patterson** of the Arizona Merchant Plant Alliance presented a brief history of the efforts in the 1990s to 'marketize' a regulated utility, with the goal of assuring that shareholders, rather than utility consumers, pay for mistakes in anticipating supply and demand, which, so far, is working in Arizona. Share prices have gone down, but utility rates have also decreased. Mr. Patterson discussed how the California deregulation experience has affected Arizona, with the goal for Arizona being that mistakes will not be paid for by the consumers. Mr. Patterson identified the goals of five years ago: shareholder responsibility, economic development, and low cost, reliable energy, which are working. He cited the Harquahala Plant in western Maricopa County as an example. The plant has been a boon to a very depressed area, has generated tax revenue, and produces low cost power, that is close and readily available to the intended market. Western Maricopa County is expected to become a regional hub for energy.

The issues identified by Mr. Patterson are (1) getting the electricity to the people, and (2) getting the gas to the generating plants. With respect to gas delivery, the plants are being built by the market, and the market will mean the gas will get to the plant. There is competition, it is chaotic, but mostly appears to be working as planned, with benefits for the consumers.

2. **Tom Carlson**, Manager of Trading for Arizona Public Service (APS), talked about gas systems at present and in the future. APS, as a customer of El Paso Natural Gas, buys natural gas to make electricity, and has also been selling the excess gas, on a daily basis, since 1995. APS buys gas from markets in New Mexico and Texas, and projects buying from Colorado and California in the future.

APS, along with SRP and a company in Florida, have been the primary drivers of change in the plan to have a reliable supply of gas for the generators. The primary source of natural gas for APS at this time is the San Juan Basin, but as this source diminishes, APS is looking for alternative sources. San Juan historically has had the lowest price, and as the percentage of supply from the San Juan decreases, costs will increase as other gas sources have usually been higher priced.

Another major concern of APS is the pipeline pressure on the El Paso pipeline, as the pressure is critical for the operation of the generators, and the compressors on the pipeline are aging.

APS' efforts to resolve these issues include working with Federal Energy Regulatory Commission (FERC) on management of pipeline capacity and consideration of the possibility of gas storage projects. Three potential natural gas storage projects are under consideration in Arizona, to assure supply for electric generators and to assure Southwest Gas will be able to serve is increasing gas customer base.

Gas pipeline expansion in California will increase the supply to markets past 2005 and 2006; however Arizona's supply needs will also increase, requiring additional pipeline capacity to be constructed. Gas storage would temporarily mitigate transportation issues, but, in time, additional pipeline capacity must be added.

3. **Steve Bateson**, Duke Trading and Marketing, discussed concerns relating to finding the gas for merchant plants, including supply and transportation. Mr. Bateson pointed out that, although there are four pipelines leading to California, there is only one in Arizona, and El Paso's pipeline is essential to supply in Arizona. FERC is trying to move to open markets for gas supply, and El Paso is presently behind the curve due to the rate settlement case.

Service is expected to change when the delivery point issues are resolved for El Paso. Buyers will have set delivery system point rights, and 'in the path' (i.e. specific transportation rights from Point A to Point B upon the El Paso System). Mr. Bateson anticipates Arizona will be disadvantaged compared to California, and it is critical that Arizona push to get its rights implemented 'in the path.'

Last year El Paso customers had to designate a delivery point, with each contract containing a specified primary point for delivery. FERC has required the same on receipt point, and has assigned receipt points. Each contract now specifies known receipt and delivery points.

In the future, capacity is to have a path, with 'in the path' capacity having priority. Flexing the delivery point will be possible, but will drop the shipper's priority. With 'segmentation', the shipper will be able to break the contract into parts, and 'backhauling' will allow the shipper to bring the supply in at a delivery point and then deliver it upstream.

4. **Douglas Fant, Esq.,** presented information on the current and projected market demand for natural gas. Current annual nationwide natural gas production is 20 trillion cubic feet (TCF), while current nationwide demand ranges around 23 TCF. Canadian imports from western Canada make up 2.3 TCF of the difference, while liquid natural gas (LNG) imports cover the rest. There are also minor natural gas exports to Mexico. The Department of Energy recently released figures for anticipated annual domestic demand by the year 2025. Natural gas usage will climb to 35 TCF annually. Domestic and southern Canadian natural gas production has been flat for the past 5 or 6 years. For example in 2001 there was an increase of 35% in the number of nautral gas wells drilled in the state of Texas, but the total amount of gas found did not change. Thus the amount of gas reserves found per well has been declining over time.

Five major pipelines with 7.915 billion cubic feet (bcf)/day capacity serve the southwestern region; El Paso, Transwestern, Kern River, PG&E Border Pipeline, and Southern Trails. Arizona/ California/ Nevada natural gas usage averaged 7.2 bcf/day in 2001 and slightly less 7.04 bcf/day in 2002. An additional 1 bcf/day of capacity will be added to southwest by the Kern River Pipeline and El Paso Power Up expansions 2003-2004. Thus current pipeline capacity available to serve the southwestern and Arizona markets is adequate.

However projected organic growth of the region (the region is home to the four fastest growing counties in the nation- Maricopa, Los Angeles, Riverside, and Clark Counties, as well as home one of the fastest growing cities in Mexico, Mexicali), as well as projected consumption growth from construction of gas- fired generation in and around southern Nevada and the Hassayampa Hub, will increase natural gas demand and require additional natural gas pipeline capacity into Arizona to be constructed after 2004. The market should move promptly to address this issue once the uncertainty caused by the FERC El Paso Capacity Allocation decision has been resolved by FERC

Arizona should develop its own additional pipeline capacity so that Arizona shippers do not have to pay double tariff for backhauls from the Kern River System, and also to insure capacity for its power generating facilities.

Liquid Natural Gas, Pacific Markets: Peoples Republic of China under Kyoto Protocols decided to double use of natural gas in order to reduce greenhouse gas emissions. Decision will increase the PRC's natural gas usage from 5% to 10% of China's total energy mix. That decisions will draw up to 6 bcf/day out of the Pacific LNG markets and send it to three new LNG terminals announced by China. Due to demurrage rates for LNG tankers, this may delay (not stop) the development of LNG terminals upon the west coast of Mexico, just south of California. Thus LNG should not be a significant factor in southwestern region natural gas markets through 2005.

Legal Issues. Mr. Fant also provided background information on various pending legal cases that may affect the supply of gas to Arizona:

El Paso Natural Gas Co. Capacity Allocation and Complaints Proceeding- Docket No. RP01-486-000 and RP00-139-000, Federal Energy Regulatory Commission.

Key decision for Arizona shippers; FERC intends to terminate Arizona shippers' full requirements (FR) gas transport contracts in order to reestablish firm transportation service as defined in 18 CFR 284.7. FR contracts arose as part of a 1996 FERC settlement to absorb then excess capacity on El Paso System. FR shippers, located east of California, demand has grown tremendously (50% from 2 bcf/day to 3 bcf/day from 1995 to 2002) and degraded reliability of firm transportation service on El Paso System. FERC intends to terminate all FR contracts except for de minimus shippers (less than 10,000 mcf/day). FERC will convert all FR contracts to CD contracts with specific delivery and receipt points. That will ultimately cap Arizona-based FR shippers access to long-term capacity on the El Paso System.

El Paso Natural Gas Co. California Capacity and Price Manipulation Complaint- Docket No. RP00-241-000, May 4, 2000, Federal Energy Regulatory Commission

El Paso accused by State of California of manipulating capacity and gas prices during California energy crisis. Administrative Law Judge ruled in favor of State of California. FERC Commissioners heard arguments in December 2002. FERC has promised decision by March 2003.Potentially El Paso Corporation could be forced to disgorge up to $3.3b US profits from garnered that period. El Paso Corporation's annual cash flow is in the $2.8-3.0b US annually. El Paso currently posses assets in the $40b US range and $17b US debt. If ruling upheld, El Paso may seek Chapter 11bankruptcy protection and reorganize. That would slow any new investment by El Paso but otherwise not likely affect the operation of the current El Paso System.

Nevada has also filed a state court lawsuit against El Paso based upon similar theories and causes of action.

Order Instituting Rulemaking to Require California Natural Gas and Electric Utilities to Preserve Interstate Pipeline Capacity to California; Rulemaking 02-06-041, California Public Utility Commission.

California is trying to maintain control over 3.29 bcf/day of current California customer long-term delivery capacity on El Paso System. and not turning any excess long-term capacity back under FERC Capacity Allocation Decision pending above. California will assist major California-based electrical and gas utilities to control the capacity and roll any related costs into their respective utility rate bases. The California shippers will be allowed to release short-term capacity however back into the market. The decision will inhibit long-term planning by pipeline users east of California. Will the CPUC decision withstand FERC scrutiny? The FERC Southern Nevada exit cases suggest the answer to be "yes".

Southern Nevada Exit Cases, Docket No. ER02-2606, Federal Energy Regulatory Commission. See Also Public Utility Commission of Nevada Proceeding 02-5051.

FERC electric transmission case in which the State of Nevada developed "native load import rights" to protect incumbent utilities' access to retail load customers. FERC accepted the Nevada state policy to protect the utilities filed as an amendment to the Nevada utilities' Open Access Tariff. The Nevada state policy is similar to the California state policy enunciated in the above CPUC proceeding. That suggests that FERC will not also interfere with the State of California's policy to protect its utilities' control over the 3.29 bcf/day long-term pipeline capacity on the El Paso System.

PART II. OPEN DISCUSSION FOR ISSUE IDENTIFICATION.

Bob Gray, Arizona Corporation Commission identified the Commission's issues as follows:

Contract rights of the State of Arizona and the shippers
Protection of Arizona consumers and shippers
Arizona's ability to have reliable and cheap gas supply
Additional capacity – storage as a possible option

Comments by Doug Fant:

Four potential pipeline or spur alternatives have been proposed, but are in the discussion state only. Additional progress held up by FERC and El Paso decision.

Mr. Fant introduced the issue of innovative rate-based recovery of pipeline costs for Arizona shippers.

Janice Alward: Under the Arizona constitution, this could not be done for municipalities, generating plants or utilities.

Steve Bateson identified the following issues:

Sufficient gas for merchant plants
When the southern system is finished, the economic availability may be altered; with backhauls, merchant plants may be at a disadvantage in purchasing

Janice Alward:

Reliability issues need to be looked at
With respect to capacity, California's order to pick up all capacity is not likely to insure reliability for Arizona
How do merchant generators intend to keep their plants running?
How can reliability be assured?

Doug Fant:

With respect to reliability, California is locking in long term pipeline capacity. In the short term, availability for Arizona is okay (two years+). Thereafter additional Arizona capacity must be built. The market however should resolve the issue once the FERC El Paso capacity decision is issued. With respect to the safety issue (terrorism, natural disaster), in the short term, there would be short-term disruptions with utilities (less than a few weeks). However most pipeline facilities are built from standard industry skids or packages and in-line safety valves limit loss of product in a disaster. Thus long-term pipeline disruptions are unlikely, as a pipeline can be repaired fairly promptly using standard industry packages.

Paul Jones, SRP:

Storage would mitigate disaster scenario. Projects (storage) are on hold until a decision is reached in FERC/El Paso. Once people know what their delivery rights will be, the projects can move forward.

Tom Broderick (PG&E):

An issue for the ACC to consider would be tolling arrangements
[local utilities have the option to run the gas through a merchant plant, paying rent to the plant to generate power. Efficiency rates and preferences to affiliates would be factors]
Pinnacle West would consider tolling arrangements

Doug Fant:

> Additional matters the ACC might consider would be the creation of a greenhouse gas registry, and emission credits, which would protect Arizona generators and industry as GHG trading markets develop.

PART III. CONCLUSIONS.

The presentations and subsequent open discussions helped identify a number of issues related to natural gas capacity and reliability within the State of Arizona. Those area as follows:

1. Resolution of the FERC El Paso Natural Gas Co. Capacity Allocation and Complaints proceeding is necessary in order to clarify the amount of contract demand capacity which former full requirements shippers will actually control on the El Paso System.

2. Year over year demand for natural gas from 2001 to 2002 is flat for the Arizona/California/Nevada region. Thus current pipeline capacity is adequate to serve Arizona's gas markets in the near term.

3. Resolution of the El Paso case and organic growth in the region will require Arizona's pipeline capacity to be increased and gas storage to be considered subsequent to 2004.

4. California has four natural gas pipelines to serve its residents/markets, while Arizona currently has only one system. Aging system infrastructure, exposure to backhaul rates on the Kern River Pipeline System, as well as pipeline delivery pressure issues impact gas-fired plants located in Arizona.

5. Power Plant construction has generated both jobs and tax revenues and will ensure that low-cost power from the efficient new gas-fired plants will serve Arizona consumers.

6. The El Paso Natural Gas Co. California Capacity and Price Manipulation Complaint, if FERC rules against El Paso, could potentially force El Paso Corporation to seek Chapter 11 bankruptcy protection. That would slow new investment by El Paso but should not otherwise significantly affect operation of the current El Paso System.

7. There are four potential projects to expand natural gas pipeline capacity into the State of Arizona, two new main line systems and two spurs from systems that currently serve or will serve California. In addition there are three proposed natural gas storage facilities. The State of Arizona could accelerate the market's development

of new alternatives by encouraging resolution of the El Paso Capacity Allocation and Complaints proceeding.

8. The El Paso/Transwestern Systems are potentially subject to short-term interruptions through mechanical failure, acts of God, or third party intervention. However the Systems are constructed of standard pipeline industry skids and materials. Thus significant system interruptions should be limited in duration to a few weeks only.

PART IV. FUTURE MEETING SCHEDULE.

Two additional workshops will be held, one each in 2003 and 2004. Ideally representatives of the Federal Energy Regulatory Commission and the El Paso Corporation will attend and make presentations. In addition presentations from the companies that have proposed to build new natural gas pipelines into the State will be arranged.

ATTENDEES

NAME	COMPANY	TELEPHONE
Kevin R. Johnson	DUKE	713 303 2758
Tom Campbell	Lewis and Roca	602-262-5723
RALPH FURUSHIMA	SOUTH WESTERN POWER GROUP II	602-808-2004
MERRITT BROWN	MESQUITE POWER	623-386-9938
SAM LIPMAN	Desert Energy	480-860-4568
GARY BACON	MALCOLM PIRNIE, INC.	602-797-4622
Lynne L'Esperance	Malcolm Pirnie, Inc.	602-797-4624
BILL BROHMAN	PACIFIC TEXAS	480.994.8268
Judy Miller	Lewis and Roca	602-262-5731
Tom Broderick	Harquahala Gen. Co.	713-724-3576
Janice Alward	ACC-Esp.	6025423402
Gordon Pickering	Navigant Cons. Inc	916 632-3429
Carolyn Steubart	Navigant Consulting	602 528-806
Gary Cu	South Western Power Group	602 808-2004
Karilee Ramaley	Pinnacle West Capital	602-250-3626
Tom Carlson	APS	602-250-2289
Barbara Klemstine	APS	602-250-4563
STEVE MURPHY	PINNACLE WEST CAP. CORP.	602 250 4374
TODD WILEY	GALLAGHER & KENNEDY (ALLEGHENY ENERGY SUPPLY)	602 530 8514
RANDALL SIMPSON	URS CORP.	602-861-7420
Douglas V. Fant	Law Offices of Douglas V. Fant	602-770-5098
STAN BARNES	Copper State Consulting	602 229-1010
Madeline Coblenz	Duke	713 627 5222
Greg Patterson	AzCPA	602-369-4368
RICHARD HYDE	DUKE	713-627-4817

NAME	COMPANY	TELEPHONE
JASON GELLMAN	ARIZ. CORPS. COMM'N	(602) 542-3402
Larry Holly	Southwest Gas Corp.	602.395.4082
Yvonne Hunter	Pinnacle West	602-250-452[illegible]
Caroline Butler	ACC	6025423402
Steve Bateson	Duke Energy Trading + Mkt	801 531-4406
Mike Smith	Kinder-Morgan	303-763-3484
Jana Brandt	SRP	602-236-5028
Dawn Wilson	AZ Corp. Comm.	602-542-3995
Bob Gray	ACC	602-542-0827
STEVE IRVINE	ACC	602.542.0824
RAY WILLIAMSON	ACC	602-542-0828
Katie Pratt	SRP	602-236-6751
PAUL A. JONES	SRP	602-236-4520
Rufus Kelly	Duke Energy	623-882-2223
Bill Lesikar	Power Gp Corp	972 889-2100 x114