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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 convened a workshop to address gas transportation issues. The workshop was part of the November 18, 2003 AAI Energy Summit. Enclosed is a "Report on Arizona Workshop on Natural Gas Transportation Reliability and Capacity," that describes the November 18th workshop.

Very truly yours,

LEWIS AND ROCA LLP

Tom Campbell

Thomas H. Campbell

THC/mjh
Enclosure

cc: Brian K. Bozzo ACC Compliance Manager (w/enc.)

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REPORT ON ARIZONA WORKSHOP ON NATURAL GAS TRANSPORATION RELIABILITY AND CAPACITY

November 18, 2003
Scottsdale Radisson
Scottsdale, Arizona

Duke Energy North America

REPORT ON ARIZONA WORKSHOP ON NATURAL GAS TRANSPORTATION AND RELIABILITY

November 18, 2003

Pursuant to Arizona Corporation Commission ("ACC") Decision No. 64495, as amended in ACC Decision No. 64717, Duke Energy North America held the second of three annual workshops to discuss natural gas transportation and reliability in Arizona. This year, Duke incorporated its gas workshop into an Energy Summit co-sponsored with the Arizona Association of Industries. The Energy Summit was held at the Scottsdale Radisson with approximately 130 attendees from Arizona and other states. Local, state, and federal government officials spoke, as did many industry leaders.

Prior to the Summit, the ACC had issued a Notice of Inquiry (NOI) on Natural Gas Infrastructure on April 15, 2003. Numerous public and private entities responded to the NOI. An ACC workshop was held on September 10, 2003, and the ACC Staff developed a Strawman Proposal for discussion at the workshop. A second round of public comments was received that incorporated the strawman proposal and workshop discussions. All NOI documents are available on the ACC website (www.cc.state.az.us) as is "Policy Statement Regarding New Natural Gas Pipeline and Storage Costs" issued by the ACC on December 17, 2003 in Docket No. G-00000C-03-0911.

Commissioner Mike Gleason spoke at the November Energy Summit and stated that such a policy statement was in the works. He explained that the ACC currently relies on the "used and useful" standard to evaluate projects but that this may not work in the field of natural gas infrastructure construction. Pipeline and storage companies frequently need the money from signed contracts to expense their construction. Customers agreeing to these contracts and assisting with the construction expenses need assurance of how the ACC will deal with costs. Such pre-approval of up-front expenses is a radical departure for the ACC. The new policy statement, while acknowledging the traditional cost-recovery application is the ACC's preferred method, allows for alternative, pre-approval cost recovery applications as a means to encourage and expedite the development of natural gas infrastructure in Arizona.

Laurie Fitzmaurice of Sempra Energy made a presentation on the North Baja Pipeline and potential customers for the Phoenix Lateral pipeline being developed. The North Baja pipeline system was completed in September 2002 and transports natural gas 220 miles from Ehrenberg, AZ to Rosarito, Baja CA. North Baja Pipeline, LLC and Sempra Energy International jointly are conducting the LNG Pipeline Expansion open season and jointly will develop the Phoenix Lateral line. The open season was extended in response to interest expressed in new interconnections with the markets of Sonora, Mexico; and Yuma and Phoenix, Arizona. Ten end-use customers have expressed an interest for 750+ MMcf/d of capacity and LNG terminal developers and suppliers have expressed additional interest. Due to the high population growth and increased use of natural gas for power generation, Arizona has outstripped current infrastructure and supply. At the same time, North American production is in decline with nine years supply projected from the Permian Basin, and fourteen years from both the San Juan and Rocky Mountain basins. One alternative supply source is the Pacific Basin where it is estimated there are 325 Tcf of reserves in South America, Asia, and Australia. There are five LNG import projects proposed for Baja with completion dates in 2007 and 2008. Three of these five have received Federal/CRE permits. LNG terminal developers and suppliers expressed interest in 5.5 Bcf/d during the first phase of the Open Season, with 750 MMcf/d of that being for a Phoenix Lateral line. The Phoenix Lateral would consist of a 150-mile pipeline from Algodones, Baja CA through Yuma and into greater Phoenix. The U.S. portion of the pipeline would be FERC regulated. Timelines for the LNG projects, North Baja System, and Phoenix Lateral parallel each other with anticipated completion of all three components in spring 2007.

Phyllis Martin of the Department of Energy's Energy Information Administration provided a national outlook in her presentation. She noted that the new energy bill, which was being voted on the day of the conference, would impact forecasts and assumptions but that research shows the general trends in energy consumption and production remain the same over the years. Consumption continues to outpace domestic production with a net increase in natural gas imports required to meet the demand. Residential and commercial users grow at a steady pace. As prices moderate and populations increase, natural gas becomes the fuel of choice for residential consumers. Affordable natural gas now is moving into the consumer-cooling sector. Growth in the service industries is exceeding that of the manufacturing industries and within the latter sector the energy intensive industries are likewise not growing as rapidly. Electric generator consumption, however, will more than double by 2025. 80% of new power plants run on natural gas. Projections show the U.S. will need 11 Tcf of new supply by 2025. On the supply side there are 1,289 Tcf of "technically recoverable" natural gas resources in the U.S. These are found onshore, offshore, in coalbed methane, shale gas, tight gas, and in Alaska. Of U.S. dry natural gas production, only onshore unconventional in the lower 48 states shows steady growth potential into 2025, with Alaska supplies kicking in toward 2020. While imports of natural gas from Canada have increased over the past fifteen years, this will slow down, and LNG imports will make up the difference. Concurrently, Mexico will change from being a net importer of natural gas to being a net exporter. Lower 48 states wellhead prices will fluctuate around $4.00 per Kcf while industrial gas prices will remain under $5.00 Kcf. Key questions remain: will drilling costs continue to fall with discoveries per well rising; will LNG regasificaiton terminals continue to be hard to site; what is happening with the Canadian and Mexican production levels; will the Alaska natural gas pipeline become economical before 2020; what will the impact of all these factor be on prices; and how will prices affect demand.

Larry Black of Southwest Gas took a philosophical look at the "Strategy and Tactics" of Arizona's infrastructure in 2004 and beyond. Drawing from Sun Tzu's treatise "The Art of War," and the writings of other military figures, he presented strategy as the goal and the tactics being how to accomplish the strategy. Key tactics might be to maintain reserves, stockpile supplies, gather intelligence, be mobile and flexible, and form alliances. Once the goals and policies are identified we can identify the necessary tools as well as the interest and incentives of the players. Storage needs to be connected to the market; therefore, the need exists for pipelines to carry the product to this market area storage. There are obligations to serve the customer and protect investments in facilities without jeopardizing the future of either. All of this will cost money; nobody gets it without paying for it and we may not fully understand the costs of the future. Rhetoric frequently turns to what must be done now rather than to prepare a common, well thought out course of action to meet identified goals. While haste may be appropriate so also might doing nothing be a proactive decision. Knowledge is the most important thing - the more we learn the better we will ensure the most efficient and effective future.

<u>Donald Zisko of El Paso Western Pipelines</u> discussed natural gas storage. There is no natural gas storage in Arizona currently. Within the Western Consuming Region, Arizona is the only state with no storage capacity or base gas inventory and thus has no working gas capacity. Storage has multiple roles: to provide a critical source of supply during heating season; to enable stable production through out the year; to meet sudden shifts in demand and supply caused by weather; to support pipeline operations, transportation and hub services; and to enable more efficient use and investment in long-haul pipeline infrastructure. El Paso delivers gas to both electric producers and local distribution companies in Arizona. When both demands peek, it pulls pressure down in the pipeline but the demands can be met because there is excess capacity on the system. With the prospect of adding 9600 MW of gas-fired capacity by 2005, all of the current pipeline capacity will be used by 2007. Storage projects are planned in Arizona at Red Lake and Desert Crossing in Mohave County. Gas can reach these locations both from the San Juan Basin via the Kern River Pipeline and from the Baja area via the Havasu Crossover out of Ehrenberg. Because storage is needed close to the user systems, El Paso is developing a 9.6 Bcf storage facility in the salt domes at Copper Eagle in western Phoenix, with a 33 mile pipeline planned between the site and the El Paso mainline to the south that feeds the power plants in western Maricopa County. Local storage also affords new services that companies may offer including contract storage, park and loan, non-notice transportation, and firm transportation with defined hourly rights. Such services would be offered, not mandated, with the cost of services being capped by FERC. El Paso held a non-binding open season and received expressions of interest from nine parties wanting a total capacity of 9.5 Bcf. The company needs contracts to help cover the cost of the facility and line so it plans a binding open season soon. FERC filings will occur in early 2004 with construction on the storage caverns scheduled for 2007 and 2008.

<u>Michael Owens of Pacific Texas Corporation</u> discussed the company's projected 800 mile Picacho Pipeline from West Texas to Ehrenberg on the California border. The $1 billion investment would bring one billion cubic feet per day of natural gas to local distribution companies and power generators. The need exists for a clean fuel supply to support the regional population and industrial growth and to meet the natural gas demand in energy production. While it seeks FERC approval for the pipeline, PTC is presenting the benefits of the project at open houses with regional, state, and local stakeholders along the route. Political and industry leaders have expressed their support for the pipeline and encouraged the use of Arizona-based goods and services in the planning, construction and operation of the project. An open season is planned with interest anticipated from the state's major power companies as well the independent power producers and East-of-California shippers. Seen as a critical component in Arizona's economic success, failure to build this pipeline is not seen as an option by Pacific Texas Corp.

<u>Kimberly Watson of Kinder Morgan</u> described the company's Silver Canyon Pipeline planned to run from southwest Colorado, through northwest New Mexico, along Interstate 40, down through Phoenix, and west to Ehrenberg. The $950 million line will have a capacity of 750,000 MMBtu/d. The natural gas will be marketed in the Phoenix area and through Ehrenberg

to SoCalGas and Baja Norte. Sources will include the Piceance, Paradox and Green River basins in the Rocky Mountains via TransColorado, and the San Juan Basin. Adding new gas from these basins and, thus, creating more choice for consumers, should mean lower natural gas prices. The company closed an open season in April 2003, and is working with the Navajos on right of way permits to cross their land. A mid-2006 in-service date is projected if there are enough customers. To ensure that there are, the company plans to offer contractual flexibility with seasonal and sculpted contract volumes; receipt to delivery point pathing; alternate receipt and delivery points; backhauls from Ehrenberg to Phoenix; and fully segmented, Order 637 compliance. On the operational side, they will sell natural gas on both a 16 and 24 hour day, the 16 hour day being especially good for the power generators.

Mark McConnell of the Transwestern Pipeline Company was the final speaker. Two expansion projects, one completed and one under construction, will increase the company's supply of natural gas to Arizona. Their $72 million Red Rock Expansion added additional Horse Power ("HP") at three stations along their northern Arizona pipeline. This additional HP went into service in June 2002, and increased their deliveries from the Permian and Anadarko basins to 1.2 Bcf/d. Their San Juan Lateral Expansion will connect the natural gas supplies in the Rocky Mountains, via the Blanco Hub in New Mexico, to this same Transwestern pipeline. The San Juan Lateral should be operational by June 2005, and will carry up to 600,000 MMBtu/d at an estimated cost to build of $180 million. A third expansion project, (also called) the Phoenix Lateral, is in the planning stage to bring a 170 mile pipeline from Flagstaff to western Phoenix and connect with the El Paso mainline south of Palo Verde. This would bring an additional 400,000 to 500,000 MMBtu/d to the Copper Eagle storage area as well as the power generators and local distribution companies. Estimated capital costs are $251 million over an 18-month construction schedule with a line possibly in place by late 2005. As with the Kinder Morgan project, this line would increase supply flexibility by accessing gas from multiple basins, backhauling from California, and promoting competition.