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Staff Proposal for Review of Natural Gas Procurement Activities

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INTRODUCTION

In Decision Number 62994 (November 3, 2000), the Arizona Corporation Commission found that "The Commission should establish a process to review the appropriateness of gas procurement activities". This decision further ordered the Commission Staff to "hold discussions with the local distribution companies (LDCs) and other interested parties and submit a formal gas procurement review process to the Commission for approval by June 1, 2001."

In its September 6, 2000 Staff Report on the Rolling Average PGA Mechanism, Staff noted that:

> "Natural gas LDCs purchase gas on the spot market, by using basin indexes, through longer term contracts, and other means. To ensure that each LDC's customers are not paying more than they should, the Commission has historically monitored the procurement of natural gas by the LDCs. In the past when a review of gas procurement activities has taken place it was typically in the context of a rate proceeding. Given the large number of issues that are dealt with in a typical rate proceeding, the issue of gas procurement may not receive the level of attention that is warranted. Many other states have a separate gas procurement review process which takes place on some type of set schedule, such as annually or every other year. Providing a separate venue enables the state commission to provide the necessary attention to gas procurement issues. Additionally, there are cases where LDCs do not have a rate proceeding for a large number of years and therefore there is no forum for a formal review of gas procurement issues. This is troublesome from both a regulatory and an LDC perspective. If there are problems with gas procurement activities, the regulator may not discover them until many years later. For the LDC, the appropriateness of gas procurement activities remains an open question and a possible liability when there is no formal review for many years."

Because generally natural gas costs may be passed through to customers by LDCs through their purchased gas adjustor (PGA) mechanisms on a dollar for dollar basis and don't necessarily impact the LDCs' profitability, it is possible that an LDC would not have a strong incentive to apply the needed resources and effort to do the best job of procuring gas for Arizona ratepayers. Knowledge that the Commission will do a regular review of gas procurement activities will provide Arizona LDCs with a greater incentive to optimize their gas procurement activities.

This report contains a review of gas procurement issues, as well as Staff's recommendations regarding a gas procurement review process.

NATURAL GAS PROCUREMENT REVIEW OPTIONS

The review of natural gas procurement activities varies from state to state. Most states now have some method of conducting a separate, formal review of gas procurement activities by LDCs in their state. This contrasts with Arizona, where rate proceedings have traditionally been the forum for review of natural gas procurement activities. The review of natural gas procurement activities in a rate proceeding is disadvantageous because, as noted previously, there are typically a large number of complex issues that are being analyzed in rate proceedings and the issue of natural gas procurement activities may not receive the full consideration it warrants. Additionally, some LDCs may go for a sizable number of years without having a rate proceeding, possibly resulting in an LDC's natural gas procurement activities not being reviewed on a timely basis. Currently, Arizona LDCs are required to file monthly PGA reports with the Commission, documenting their natural gas purchases and sales and FERC Account 191 entries. These reports provide some information on natural gas procurement activities, but additional information may be needed to conduct a thorough review of natural gas procurement activities.

A number of factors impact the way a state undertakes its natural gas procurement reviews. One important factor that impacts how natural gas procurement activities are reviewed is the structure of the purchased gas adjustor (PGA) mechanism being used in a particular state. For example, a number of other states reset their PGA rate(s) annually. In states like these, it often follows that at the time the PGA rate is being set, the state also reviews the LDCs' natural gas procurement activities. By contrast, currently in Arizona the PGA rate automatically adjusts on a monthly basis and there is no set periodic review of natural gas procurement activities. Therefore, the implementation of a review process specifically related to natural gas procurement activities in Arizona is appropriate and necessary.

STANDARD FOR APPROPRIATENESS OF GAS PROCUREMENT ACTIVITIES

One key element of a well structured gas procurement review process is a clear definition of what standard(s) will be applied to determine the appropriateness of a given LDC's gas procurement activities. Setting a clear standard is beneficial to the LDCs, the Commission, and Arizona ratepayers. A clear standard will allow the LDCs to have a clearer understanding of what is expected of them when they purchase natural gas and the Commission will have a consistent standard to apply to all LDCs into the future.

During 1998-1999, the PGA Design Working Group met a number of times to work on designing the rolling average PGA mechanism that was adopted for all Arizona LDCs (except Bagdad Copper Market) by the Commission in Decision No. 61225 (October 30, 1998). Given Bagdad Copper Market's unique circumstances, the Commission retained the fixed PGA rate for Bagdad. In working group discussions, some LDCs expressed a concern regarding their ability to recover gas costs that were incurred under longer term contracts, as compared to spot market purchases. To address these concerns, while retaining the Commission's ability to review these purchases, the Commission adopted the following language in Decision No. 61225:

> "As a general principle, subject to the circumstances of any specific matter: if a contract appeared to be prudent and reasonable at the time it was entered into, given market conditions and other relevant factors, the utility should be permitted an opportunity to recover the gas costs associated with the contract. However, the Commission has the right to review all LDC gas purchases on a case by case basis."

Recommended Standard for Arizona

Some other states identify a specific standard while others do not. Of states that set some type of standard, many use some form of the "known or should have known" standard. For example, in Colorado's Gas Cost Adjustment Rules, Rule 723-8-8 states that:

> "For purposes of GCA recovery, the standard of review to be utilized by the Commission in assessing the action (or lack of action) of a utility in a specific Gas Purchase Year shall be whether the action (or lack of action) of a utility was reasonable in light of the information known, or which should have been known, at the time of the action (or lack of action)."

The "known or should have known" standard is a reasonable balance of the LDCs' and ratepayers' interests and Staff recommends that this standard be adopted by the ACC for evaluating gas procurement activities. This standard is consistent with the previously adopted standard regarding longer term gas purchase contracts, but would be applicable across the entire gas procurement process.

Staff recommends that the Commission adopt the following language as the standard in Arizona for determining the appropriateness of natural gas procurement activities.

> "In determining the prudence of natural gas procurement activities, the standard to be applied is whether each individual action, and the utility's actions taken as a whole, given the specific circumstances at the time, is/are reasonable in light of what the utility knew or should have known at that time."

In previous proceedings the Commission has recognized a number of goals that Arizona LDCs should pursue in their natural gas procurement process, including reliability, price, and price stability. When the proposed standard for reviewing gas procurement activities is applied, these previously stated goals should taken into consideration.

Spot Market Purchases

Some LDCs have traditionally viewed spot market purchases as being the "safest" type of purchase in a regulatory review process because the company would be merely buying natural gas at the market price. In some cases this led LDCs to heavily rely on spot market purchases for their natural gas supplies. Such heavy reliance on spot market purchases exposes an LDC and its ratepayers to greater price volatility than a similarly situated LDC that diversifies its supply portfolio. Given the ACC's recognition of price stability as one of the goals of the gas procurement process, a simple reliance on spot market purchases cannot be assumed to be an appropriate gas procurement strategy. Similarly, the purchasing of a set percentage of gas by LDCs under longer term fixed price contracts should not be assumed to automatically meet the Commission's goal of price stability. For example, if an LDC had been buying twenty percent of its natural gas under fixed price contracts for the past three years, but there was a strong indication that prices would rise significantly during the next winter heating season, the LDC should consider entering into contracts to buy a higher percentage of its natural gas during the next winter heating season under longer term fixed price contracts.

PROPOSAL FOR REVIEWING NATURAL GAS PROCUREMENT ACTIVITIES

It is important to undertake a review of each LDC's natural gas procurement activities on a regular basis, but if such a review occurs too frequently, it becomes an unnecessary burden on both the Commission and the LDC. To balance these considerations, Staff recommends a three year review cycle as reasonable and appropriate. The process would entail conducting an initial review of each LDC's gas procurement activities in recent years and setting up a regular schedule for the future, such that in the future each LDC's gas procurement activities would be reviewed every three years. The LDCs would be divided up within the three year cycle. Because Citizens Utilities and Southwest Gas are the largest and most complex LDCs, their gas procurement activities would be the only ones reviewed in their years during the three year cycle. During the remaining year of the three year cycle, Arizona's other remaining LDCs, including Bagdad Copper Market, Black Mountain Gas, Duncan Rural Services, Energy West, and Graham County Utilities, would have their gas procurement activities reviewed. One benefit of staggering the LDC reviews over a three year period is that each year the Commission Staff will be able to focus on a limited number of companies (in some years only one company). This allows for a more thorough review and analysis than attempting to review all LDCs within one year.

Each review in the three year cycle will review the natural gas procurement activities during the three previous calendar years. For example, if Staff was conducting a review of natural gas procurement activities in 2005 for an LDC, the natural gas procurement activities from 2002 through 2004 would be analyzed. Due to the timing lag in gas procurement reporting, it would take the first several months in 2005 for the LDC to finalize its PGA information through the end of 2004. Therefore, under this example, it is anticipated that Staff would initiate its review of the LDC's natural gas procurement activities at the end of the first quarter in 2005. Staff would conduct its review and would file its report with the Commission by the end of August that year, 2005 in this example. It should be noted that in the first three year cycle, each review would cover gas procurement activities beginning at the point at which the initial (historical) review ended.

At this time many LDCs have not had their natural gas procurement activities thoroughly reviewed for a significant amount of time. Once a review procedure is approved by the Commission, Staff would undertake a review of past procurement activities for Arizona LDCs. This would allow the Commission to become current in its review of natural gas procurement activities. Once this initial review was completed, the three year review cycle would commence. It is unclear at this time how long this initial gas procurement review will take Staff to complete, due to the newness of the process, the need to obtain additional information from the LDCs, and other factors.

One issue that must be resolved is how far back these initial reviews will go. It would be difficult, at least in some cases, to go back to the last time a review was conducted on natural gas procurement activities. Not only would it be very time consuming to go back many years, but it will likely be increasingly difficult to obtain all the records and other information required. Additionally, there have been changes in the natural gas industry and in the manner that natural gas costs have been accounted for and passed through to customers over the years. These factors would add to the complexity of a review which would go back many years. However, Staff believes that it is important to review past gas procurement activities to ensure that Arizona ratepayer concerns have been properly considered in the purchasing of natural gas in recent years. In light of these circumstances, Staff believes that a proper balancing of the issues would be to conduct the review of past natural gas procurement activities on procurement activities from the implementation of the June 1999 PGA mechanism to the present time.

It is anticipated that once the initial reviews are completed, the dates for the various steps in the three year cycle will be finalized. When Staff completes its initial reviews, it will file a letter finalizing the three year cycle dates.

Under Staff's proposals, when Staff completes its review of an LDC's natural gas procurement activities, Staff would file a report documenting its review. The Staff report and recommendations would be brought to the Commission for approval at open meeting. There may be some gas procurement information which the LDCs would consider to be confidential in nature. If Staff agrees the information is proprietary, confidentiality agreements can be executed to protect the information from public disclosure. Staff would then file a separate public version of its gas procurement review.

It should be noted that Arizona LDCs vary greatly in size and that the gas procurement activities of a small LDC will differ greatly from those of a large LDC. For example, it is difficult for an LDC with a very small throughput to diversify its supply portfolio, an LDC with a large throughput has many more opportunities to diversify its supply portfolio.

SCOPE OF NATURAL GAS PROCUREMENT REVIEW

The natural gas procurement review would have two main goals: (1) to analyze the LDC's natural gas supply purchases and related activities during the period under review; and (2) to ensure that the natural gas supply purchases have been properly accounted for in the LDC's Account Number 191, which is the account where the LDCs record their purchased gas adjustor activity.

The analysis of the LDC's natural gas supply purchases would include review of all applicable charges and credits that are passed through the purchased gas adjustor mechanism. This would include the commodity purchases, the costs of delivering the natural gas to the LDC's system, storage related costs, and other costs and credits. These costs and credits would be evaluated by applying the "known or should have known" standard described above to each natural gas purchase by the LDC.

Some LDCs have sales beyond their sales to core customers. Examples of these sales include special gas procurement agreements and negotiated sales program agreements. As part of the natural gas procurement review, the sales to these customers would be compared to sales to core customers to ensure that non-core customers are not receiving preferential treatment.

The second goal of the natural gas procurement review would be ensuring proper accounting of natural gas supply related costs and credits. This would involve a review of the monthly inputs into each LDC's PGA bank balance account.

Additionally, the natural gas procurement review process would provide the Commission with the opportunity to provide further direction to the LDCs regarding their natural gas procurement activities. For example, if the Commission wished to direct the LDCs to pursue natural gas storage opportunities to further enhance supply reliability, the gas procurement review process would be a forum for such issues to be addressed.

USE OF FINDINGS FROM PROPOSED NATURAL GAS PROCUREMENT REVIEW

At the end of a given review by Staff of an LDC's natural gas procurement activities, Staff would file a report which would document its review of the LDC's natural gas procurement activities. This report would also contain findings regarding the properness of the LDC's natural gas procurement activities during the period under review. Such findings could be considered by the Commission in future rate cases and other proceedings as is deemed necessary. If Staff finds improper actions in the procurement of natural gas by the LDC, the Commission could take timely action to address the situation, such as filing an Order to Show Cause. It is generally anticipated that such action would only be taken if serious problems were found in the LDC's natural gas procurement activities.

CONCLUSIONS

The procurement of natural gas is an important process that has a significant impact upon the rates and quality of service that Arizona natural gas consumers experience. Establishment of a comprehensive natural gas procurement process will signal the industry that the Commission recognizes that Arizona LDCs must optimize their gas procurement efforts. A process that is clearly defined will provide greater certainty for the LDCs, the Commission, and Arizona ratepayers. Both the Commission and the LDCs bear responsibility in ensuring that Arizona ratepayers are best served in the purchasing of natural gas. It is important that each LDC actively pursues an optimal gas procurement strategy, rather than merely procuring gas in a way which the LDC believes would minimize the regulatory review of its purchases. A Commission adopted standard would result in a consistent review of natural gas procurement activities so the LDCs will know what is expected of them.

Staff believes that the gas procurement review process contemplated in this report would enable the Commission to effectively monitor the gas procurement activities of Arizona LDCs. Although Staff has solicited input from interested parties in preparation of this report, and has had informal discussions with a few interested parties, Staff has not received much input from interested parties to this point. In light of the limited response, and given recent events in the natural gas market and other energy markets, Staff believes that it would be beneficial for the Commission to hold one or more workshops on the design of a natural gas procurement review process. Such a workshop or workshops would provide all parties, including the Commissioners, with a greater opportunity to discuss the issues related to the review of natural gas procurement activities and provide input to Staff on the design of a review process. The gas procurement process contemplated in this report could serve as a starting point for discussions at the workshop(s). If the Commission agrees that this approach is acceptable, Staff anticipates quickly scheduling a first workshop. After the first workshop, input would be sought as to whether additional workshops would be needed. After completion of the necessary workshop(s), Staff would consider the position of all parties, would prepare a revised report, and would bring an updated gas procurement review process to the Commission for approval.