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IN THE MATTER OF THE GENERIC PROCEEDING CONCERNING ELECTRIC RESTRUCTURING ISSUES.	DOCKET NO. E-00000A-02-0051
IN THE MATTER OF THE GENERIC PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR.	DOCKET NO. E-00000A-01-0630
IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION.	DOCKET NO. E-01933A-02-0069
IN THE MATTER OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR A VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606	DOCKET NO. E-01345A-01-0822

TUCSON ELECTRIC POWER COMPANY'S REPLY IN SUPPORT OF MOTION FOR DECLARATORY ORDER

Tucson Electric Power Company ("TEP"), through undersigned counsel, respectfully submits this reply in support of the "Tucson Electric Power Company's Motion for Declaratory Order and Request for Procedural Conference in Docket No. E-01933A-04-0408" that was filed with the Commission on May 4, 2005 (the "Motion for Declaratory Order"), as follows:

I. INTRODUCTION.

The differences of opinion expressed in the various responses filed to the Motion for Declaratory Order underscore the need for the Arizona Corporation Commission ("Commission") to clarify the authorized method for TEP to determine the rate for standard offer generation service, after the current Competition Transition Charge ("CTC") terminates on December 31,

2008. The issue presented by the Motion for Declaratory Order, although wide ranging in its consequences, is actually very specific:

> Will TEP continue to charge its standard offer generation service rate based upon the MGC after the Floating CTC terminates on December 31, 2008?[1] (sometimes referred to herein as "the issue")

The purpose of the Motion for Declaratory Order is to formally raise the issue for Commission consideration. TEP supports Commission Staff's request for a procedural conference in the 2004 Rate Review proceeding (Docket No. E-01933-04-0408). TEP further recommends that a schedule and proceeding to resolve the issue be implemented at the procedural conference.[2] TEP also supports Commission Staff's suggestion that any such proceeding include pre-filed testimony.[3]

TEP recognizes that based on current market conditions, it is likely that customers will experience a significant rate increase after December 31, 2008, when the Floating CTC is no longer in effect. In order to mitigate any such rate increase for customers and at the same time not negatively impact the utility, TEP proposes that the parties to the 1999 Settlement Agreement negotiate a modification thereof, which would incorporate four basic and important principles:

1. An extension of the existing rate freeze at current rates;
2. Retention of the current CTC amortization schedule;
3. A commitment not to seek rate treatment for certain TEP generation assets; and
4. Implementation of a mechanism to protect TEP from extreme fuel market volatility after December 31, 2008.

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[1] The corollary to this issue is, "In light of changed circumstances, can the parties to the 1999 Settlement Agreement create a new, long-term approach that protects customers and TEP?"

[2] TEP has previously requested a procedural conference in the 2004 Rate Review proceeding to address the status of that case pending resolution of the Motion for Declaratory Order.

[3] On May 31, 2005, the parties to the 2004 Rate Review proceeding filed with the Commission a stipulation staying the deadlines in that case.

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II. OVERVIEW.

The Responses demonstrate that some of the Respondents may have a general misunderstanding as to the calculation of TEP's standard offer generation service rate, the Market Generation Credit ("MGC') and the CTC. In support of the Motion for Declaratory Order, TEP provides the following overview of these three components of the 1999 Settlement Agreement:

A. Calculation of TEP's Standard Offer Generation Service Rate Under the 1999 Settlement Agreement.

Prior to the 1999 Settlement Agreement, TEP's customer bills were calculated on a "bundled" basis. This meant that customers were charged a single price for the delivery of electric service, including generation, transmission, and distribution of energy, as well as related activities such as metering and billing.

Under the 1999 Settlement Agreement, TEP agreed to "unbundle" its bills. As a result, all of the previously bundled services are now billed at separate rates. TEP also agreed that the total of unbundled charges would be equal to the previous total bundled charges (in other words, rates would not increase as a result of unbundling services.)

A TEP customer's monthly bill now lists each of the unbundled services, categorized in three main groups: Competitive Services, TEP Delivery Services, and Taxes and Assessments. The generation of electricity is classified as a "Competitive Service." The components and format of TEP's monthly customer bills were submitted to Commission Staff for approval prior to distribution to customers. A copy of a sample TEP customer bill listing unbundled services is attached hereto as Exhibit "1" and incorporated herein by this reference.

In order for a customer to consider a competitive energy provider, the customer must be able to compare TEP's price with a competitor's offering. The price to compare is identified as "Generation of Electricity" on the TEP bill, under the category of Competitive Services. This price will reflect the seasonal nature of the market price of electricity. The price of the generation of electricity is determined by applying the MGC. The MGC that is used to determine TEP's price

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for standard offer generation services was agreed to in the 1999 Settlement Agreement and approved by the Commission in Decision No. 62103.[4]

B. The MGC.

Since the Commission approved the 1999 Settlement Agreement in Decision No. 62103, TEP's standard offer rate for generation service has been calculated by applying the MGC.[5] TEP Tariff No. MGC-1 states:

> There are two purposes of the MGC. The first is to establish a price to which TEP's energy customers can compare to the prices of competitors. The second purpose is to enable the calculation of the variable or "floating" component of TEP's stranded cost recovery.

The MGC incorporates the Dow Jones Palo Verde Index for electric generation prices. A copy of TEP Tariff No. MGC-1 is attached hereto as Exhibit "2" and incorporated herein by this reference.

There is nothing in the 1999 Settlement Agreement or in any other Commission order or rule that (i) terminates the use of the MGC for calculating TEP's standard offer generation service rate or (ii) authorizes TEP's standard offer generation service rate to be determined in any other way. And, the law is clear that TEP can only charge those rates authorized by the Commission. El Paso & S.W.R. Co. v. Arizona Corp. Comm'n, 51 F.2d 573, 576 (D.C. Ariz. 1931)

Consequently, absent further Commission action, TEP will continue to calculate its standard offer generation service rate by applying the MGC. Denial of the Motion for Declaratory Order or inaction by the Commission will have the effect of assuring that TEP's standard offer generation service rate will be calculated by applying the MGC subsequent to December 31, 2008.

C. The Floating CTC.

The Floating CTC is a temporary mechanism that was introduced in the 1999 Settlement Agreement (and authorized by the Commission). TEP applies the Floating CTC to its customers'

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[4] See Exhibit 1 at "Generation of Electricity."

[5] The MGC was modified by the Commission in Decision No. 65751.

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bills (as either a positive or negative amount) to assure that customers do not pay more than the $.08/kwh rate set forth in Decision No. 62103 for electric service during the transition period to competition. For example, if the standard offer generation service rate, as calculated by the MGC, (hereafter the "MGC rate") would cause the overall rate to be higher than $.08/kwh, then the Floating CTC would be applied as a credit on the customer's bill to bring the MGC rate down to the $.08/kwh rate. See e.g. Exhibit 1 at "Competition Transition Charge".

The Floating CTC terminates on December 31, 2008. Thus, absent further Commission action, after December 31, 2008, the rate that TEP's customers will pay for standard offer generation service will be the MGC without an offset by the Floating CTC. In principle, customers' rates will either increase or decrease without the Floating CTC in place. In reality, if the Floating CTC were to terminate today, based upon market prices for generation service, TEP's customers would experience a significant rate increase. Indeed, to date, the Floating CTC has saved TEP's customers over $1.3 billion in rate relief.

D. TEP's Reliance Upon the Terms of the 1999 Settlement Agreement and Decision No. 62103.

TEP has been adhering to, and is in compliance with, the 1999 Settlement Agreement's terms. Pursuant to the 1999 Settlement Agreement, TEP has (i) implemented two rate decreases; (ii) maintained a rate increase moratorium through December 31, 2008 (although rates could decrease); (iii) unbundled its rates; (iv) accelerated depreciation of assets; (v) offset standard offer generation service by the amount of the Floating CTC (in excess of $1.3 billion); (v) opened its previously exclusive CC&N territory to competitors; and (vi) dismissed court appeals of Commission decisions. Each of these actions provides direct benefits to TEP's customers, at the utility's expense.

TEP has taken each of these actions in good faith and in reliance upon the fact that its standard offer generation rate would continue to be determined by the MGC beyond December 31, 2008. Although there was and is no guarantee that TEP will be able to profitably earn a return through market-based rates, it is the ability to charge market-based rates after 2008 that provides

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economic symmetry to the 1999 Settlement Agreement. The opportunity to charge market-based rates was a key incentive (and in fact, a quid pro quo) upon which TEP relied, in agreeing to take the actions that have provided direct benefits for TEP's customers, at the utility's expense.

In addition to the legal claims that would arise, it would be inequitable for the Commission--at this point in time, after TEP has provided all of the enumerated benefits to customers--to unilaterally modify the 1999 Settlement Agreement in a way that would prohibit TEP from charging market-based rates (using the MGC) for its standard offer generation service. Indeed, in Decision No. 62103, the Commission found that the 1999 Settlement Agreement was in the public interest. Absent a mutually agreed-upon modification of the terms, the 1999 Settlement Agreement should continue as is, and TEP's standard offer generation service rate should be determined by the MGC, subsequent to December 31, 2008. If the Commission believes that the 1999 Settlement Agreement has been, and no longer is in effect, then TEP should be permitted, among other things, to amend the 2004 Rate Review filing to request a rate increase.

E. TEP's Proposal to Modify the 1999 Settlement Agreement.

The 1999 Settlement Agreement was rooted in the Commission's Electric Competition Rules. TEP's Motion for Declaratory Order identifies several events that have occurred since the Commission approved the 1999 Settlement Agreement, which have either modified the terms of the original agreement or have otherwise called into the question the continued viability of the Electric Competition Rules. These events include the Commission's decisions in Decision No. 65154 ("Track A"), Decision No. 65753 ("Track B") and Decision No. 67744 (the "APS Rate Case") as well as the Arizona Court of Appeals' decision in Phelps Dodge Corp. v Arizona Elec. Power Co-op., Inc., 207 Ariz. 95, 83 P.3d 573 (App. 2004). The combination of these events provided the impetus for TEP to file its Motion for Declaratory Order.

Although TEP would prefer that its standard offer generation service rate continue to be calculated with the MGC after December 31, 2008, it is concerned that as a result of the termination of the Floating CTC on December 31, 2008, its customers will be subject to a significant rate increase in 2009. At the same time, TEP does not believe that any actions should

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be taken to wrongfully deny the utility the benefit of the bargain of the 1999 Settlement Agreement. Accordingly, TEP has analyzed how the 1999 Settlement Agreement can be modified so as to (i) preserve the intent of the parties; (ii) avoid a significant rate increase in 2009; (iii) mitigate a negative financial impact on TEP; and (iv) provide all parties with certainty for the near future. TEP believes that all of these goals can be achieved through a modification of the 1999 Settlement Agreement that includes the following concepts:

1. An extension of the existing rate freeze at current rates;
2. Retention of the current CTC amortization schedule;
3. A commitment not to seek rate treatment for certain TEP generation assets; and
4. Implementation of a mechanism to protect TEP from extreme fuel market volatility after December 31, 2008.

TEP will formally discuss its proposal with the parties to the 1999 Settlement Agreement and Commission Staff and, thereafter, enter into formal negotiations to modify the 1999 Settlement Agreement. TEP recommends that the procedure for negotiating a modification of the 1999 Settlement Agreement and any related hearings be a topic for the requested procedural conference.

III. SUMMARY OF THE PARTIES' RESPONSES.

Responses to the Motion for Declaratory Order were filed by the Arizonans for Electric Choice and Competition ("AECC"), Residential Utility Consumer Office ("RUCO"), Arizona Utility Investors Association ("AUIA") and Commission Staff. Those Responses reflect differing interpretations of the status of the Electric Competition Rules and the 1999 Settlement Agreement as well as speculation as to the future of electric competition in Arizona. The Responses also demonstrate some misunderstanding as to the effect of the Track A order on TEP and its standard offer generation service rate. As mentioned previously, the disparity of viewpoints reflected in the Responses clearly demonstrates that an immediate need exists for the Commission to clarify its position regarding the future of TEP's standard offer generation service rate.

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A. Summary of AECC's Response.

The AECC Response joins TEP in urging the Commission to address the status of the Electric Competition Rules. [AECC Response at 1, 2.] However, AECC disagrees that TEP's rate proceeding is the proper forum for such a review. [*Id.* at 1, 3.] According to AECC, these industry-wide issues are more appropriately addressed in the Commission's generic docket on electric restructuring. [*Id.*]

The AECC Response also argues that because of the Track A order, there is no uncertainty surrounding the Commission's treatment of TEP's generation assets after 2008. AECC argues that TEP was, or should have been, fully aware of the ramifications that the Track A order would have on the 1999 Settlement Agreement, yet TEP chose not to challenge or appeal the decision. [Response at 3.]

AECC, citing section 4.1 of the 1999 Settlement Agreement, claims that "[b]ecause standard offer generation was calculated using cost-of-service standards at that time, TEP's standard offer rates reflect traditional cost-of-service principles." [*Id.*] Notwithstanding this, AECC supports TEP's request for a declaratory order concerning the post-2008 treatment of TEP's generation assets, "provided it is consistent with past decisions regarding divestiture and market-based rate authority." [*Id.*]

B. Summary of the AUIA Response.

In its Response, the AUIA requests that the Commission grant the Motion for Declaratory Order. In support of its position, the AUIA notes that the differing views presented by the interested parties, in and of themselves, justify a procedural conference and, if necessary, a clarifying order. [AUIA Response at 2.] The AUIA also believes that the crux of the matter underlying the Motion for Declaratory Order is the interpretation of the 1999 Settlement Agreement and what it means for rates at the end of 2008, after the rate freeze expires. According to the AUIA, under the 1999 Settlement Agreement:

- TEP must cancel the fixed component of the CTC when it has recovered a total of $450 million (which AUIA anticipates will happen in mid-2008). [AUIA Response at 2.]
- TEP must terminate the floating CTC at the end of 2008. [*Id.*]
- TEP is not required to take any other action on December 31, 2008, or in anticipation of it. For example, TEP is not required to bring a rate case, nor does the 1999 TEP Settlement Agreement terminate the MGC. [*Id.*]
- Generation will be deregulated after 2008. Thus, absent some intervening Commission action, TEP's post-2008 generation rates are market-based, using an amended form of the MGC. [*Id.*]

The AUIA indicates that it has fielded a number of questions from financial analysts, who are seeking clarification of TEP's rate authority at the end of 2008. [*Id.* at 2.] According to the AUIA, the investment community "deserves to know sooner rather than later whether the Commission intends to change course. . . .If the Commission is motivated to chart a course other than the one prescribed by the [1999] Settlement Agreement, now is the time to consider it, in the context of the TEP rate filing, which contains enough data on fair value to support a forward-looking rate decision." [*Id.* at 2-3.]

C. <u>Summary of RUCO's Response</u>.

RUCO's Response takes issue with the Motion for Declaratory Order's foundational premise that after December 31, 2008, TEP's generation service rates will be based on the MGC. According to RUCO, there is nothing in the 1999 Settlement Agreement that suggests that after 2008, the MGC will still be used to set the standard offer price of electricity. [RUCO Response at 4.] According to RUCO, the MGC's only purpose under the 1999 Settlement Agreement is as a mechanism to determine the floating CTC. [*Id.*] RUCO argues that R14-2-1606(A)'s requirement that Standard Offer Service be made available "at regulated rates" will resume after December 31, 2008. [*Id.*] .

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RUCO also argues that resuming cost-based standard offer rates after 2008 is consistent with what the Commission found and ordered in Track A. [*Id.* at 4.] Therefore, according to RUCO, the Commission has already acted to substantially diminish the wholesale electric market's influence on TEP's costs to meet its standard offer load. [*Id.* at 6.] RUCO indicates that it would not oppose a Commission declaration reconfirming Track A's conclusion that TEP would not be required to rely on the wholesale market to obtain power for standard offer customers. [*Id.*]

In its Response, RUCO contends that it is unnecessary and would be bad public policy for the Commission to decide, at this time, the exact ratemaking treatment that will be afforded TEP's generation assets after December 31, 2008. [*Id.* at 6.] According to RUCO, the analysis required to consider the ratemaking treatment at this time would be speculative and premature.

RUCO concludes by arguing that a procedural conference is unnecessary and the Commission should proceed with the rate review proceeding as scheduled.

D. <u>Summary of Commission Staff's Request For Procedural Order and Response to TEP's Action For Declaratory Order</u>.

Commission Staff raises three principal arguments in response to TEP's Motion for Declaratory Order. Staff argues that TEP's assertions are inconsistent with both the 1999 Settlement Agreement and the Track A order. Staff concludes, therefore, that no basis exists for the Commission to grant TEP its requested relief. [Staff Response at 2-3.]

Specifically, Staff disagrees with TEP's description of the 1999 Settlement Agreement's "foundational premise." Staff asserts that the 1999 Settlement Agreement is silent as to how the Commission was to set standard offer rates after 2008. [Staff Response at 2.] Given this silence, Staff contends that no reason exists to presume that the Commission intended to depart from the provisions of the Electric Competition Rules, which classify "standard offer service" as a non-competitive service and provide that standard offer rates "shall reflect the costs of providing the service." [*Id.*]

Commission Staff also argues that even if TEP's description of the 1999 Settlement Agreement's foundational premise were undisputed, it has been "erased" by the Track A order.

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According to Commission Staff, the Track A order contemplates that TEP will retain its generation assets and that those assets will be dedicated to serving TEP's customers on a traditional cost-of-service basis. [*Id.*]

Commission Staff alternatively argues that if the Commission entertains TEP's Motion for Declaratory Order, then TEP should be required to file testimony to explain and support its Motion. [Staff Response at 3-4.] Specifically, Staff argues TEP should be required to prefile testimony that (a) describes the specific factual basis for its allegations, (b) identifies the specific relief that it is requesting and (c) explains why its requested relief is justified by its factual allegations (e.g., the legal analysis that might support its requested relief). [*Id.* at 3.]

Finally, Commission Staff argues that regardless of whether the Commission grants or denies the Motion for Declaratory Order or orders TEP to prefile testimony, the Commission should modify the procedural order that governs TEP's pending rate case to allow an immediate and indefinite continuance of the filing deadlines in that case. [*Id.* at 4] Staff suggests that an indefinite continuance of the filing deadlines is warranted "at least until TEP has clarified its intentions, either by filing whatever supplemental information it intends to file or by indicating that it does not intend to do so." [*Id.*]

IV. TEP's REPLY TO THE RESPONSES TO THE MOTION FOR DECLARATORY ORDER.

A. TEP's Reply to AECC's Response.

AECC erroneously argues that the Track A prohibition on the divestiture of generation assets answers the question of whether TEP's standard offer generation service rate will be determined by the MGC, after December 31, 2008.

AECC argues that because TEP is prohibited from divesting its generation assets, standard offer generation service must be calculated by a "cost-of-service" methodology after December 31, 2008. [AECC Response at 3.] However, there is no consequential link between the divestiture of TEP's generation assets and how TEP's standard offer generation service rate is calculated. There

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is nothing in the Electric Competition Rules, the 1999 Settlement Agreement, Decision No. 62103, Track A or Track B that conditions the calculation of TEP's standard offer generation service rate by the MGC upon the divestiture of TEP's generation assets.[6] In fact (i) TEP has not divested those assets and; (ii) pursuant to the 1999 Settlement Agreement, has been calculating its standard offer generation service rate by the MGC since the issuance of Decision No. 62103.

Furthermore, (i) TEP's standard offer generation service rate was not the subject of Track A; (ii) the Track A order does not address TEP's rates; and (iii) there is nothing in the Track A order (nor has AECC cited anything) that states that after December 31, 2008, TEP's standard offer generation rate will be calculated by a means other than the MGC.

AECC also missteps in its criticism that TEP should have been aware of the ramifications of the Track A order on TEP's standard offer generation service rate and consequently appealed the Track A order if it disagreed with the outcome [See AECC Response at 3.]. As already noted, there are no ramifications from the Track A order on TEP's standard offer generation service rate. Furthermore, TEP believes that if it had attempted to appeal the Track A order, parties to the 1999 Settlement Agreement (including AECC) would have argued that such action was a breach of TEP's obligation to assist the Commission in the implementation of competition in Arizona. Finally, AECC argues that "because standard offer generation was calculated using cost-of-service standards...TEP's standard offer rates reflect traditional cost-of-service principles." [AECC Response at 3.] However, AECC fails to acknowledge that TEP's standard offer generation service rate is calculated using the MGC and Fixed and Floating CTCs which are not considered to be "cost –of-service principles."

B. TEP's Reply to the AUIA Response.

The AUIA's Response supports the Motion for Declaratory Order. AUIA is uniquely qualified to provide the Commission with information regarding the concerns of the financial

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[6] Section 3 of the 1999 Settlement Agreement required TEP to obtain power from the competitive market place upon divestiture of generation assets in accordance with the Electric Competition Rules. This provision is distinct from the requirement to charge a standard offer generation rate based upon the MGC in Section 2 of the 1999 Settlement Agreement. Moreover, even AECC agrees that the status of the Electric Competition Rules is uncertain.

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community and has indicated that analysts have inquired regarding the uncertainty surrounding the Electric Competition Rules. [AUIA Response at 2.] AUIA indicates that the financial markets are looking now to see how the Commission will address TEP's generation rates in the future and that "[t]he issue will simply become more turbulent as we near the end of 2008." [*Id.*]

TEP agrees with AUIA's conclusion that "absent some intervening action by the Commission, TEP's generation rates after 2008 would be based on the amended form of the MGC, the Palo Verde Index."[*Id.*] TEP also concurs with AUIA that "if the Commission is motivated to chart a course other than the one prescribed by the Settlement Agreement, now is the time to consider it, in the context of the TEP rate filing, which contains enough data on fair value to support a forward-looking rate decision." [*Id.* at 3.]

C. <u>TEP's Reply to RUCO's Response</u>.

RUCO challenges the 1999 Settlement Agreement requirement that TEP must continue to determine its standard offer generation service rate by the MGC after December 31, 2008. [RUCO Response at 1.] But, RUCO's position is not supported by the facts.

For example, RUCO implicitly acknowledges that presently the MGC is being used to "set the standard offer price of electricity." (RUCO Response at 4) RUCO also accurately notes that there is nothing in the 1999 Settlement Agreement that changes the way that TEP will calculate its standard offer generation service rate after December 31, 2008. (*Id.* at 3) At the same time, RUCO acknowledges that after December 31, 2008, neither the fixed nor floating CTC will be included in rates. (*Id.*).

RUCO misunderstands the MGC's purpose. RUCO erroneously states that "[t]he only purpose of the MGC under the [1999 Settlement] Agreement is as a mechanism to determine the floating CTC." [*Id.* at 4]. But, as previously noted, the MGC has at least two purposes. One is to establish a price to which TEP's customers can compare the prices of competitors. Another purpose is to enable the calculation of the variable or "floating" component of TEP's stranded cost recovery. [See Exhibit 2 hereto, "Tariff MGC-1".] Thus, even when the CTC goes away, at a minimum, the MGC is necessary to set the price against which TEP's customers can compare the

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prices of TEP's competitors. If the Commission were to eliminate a market based price for TEP's standard offer generation service, as proposed by RUCO, it would effectively preclude any potential for electric competition. No party has suggested that the Commission should take such a step. And although RUCO states that "there is nothing in the [1999 Settlement] Agreement that suggests that, after 2008, the MGC would still be used to set the standard offer price of electricity". [RUCO Response at 4], the reality is that there is nothing in the 1999 Settlement Agreement that terminates the MGC as the means by determining TEP's standard offer generation service rate is calculated.

RUCO also misconstrues Track A's effect. RUCO erroneously states, "The continued implementation of cost-based Standard Offer rates after 2008 is consistent with what the Commission found and ordered in Track A". [RUCO Response at 4] But, RUCO's notion that there will be "continued implementation of cost-based Standard Offer rates after 2008" is factually wrong. TEP's standard offer generation service rate is currently "market-based," not "cost-based."

It would be inequitable for the Commission to permit TEP to perform all of its obligations under the 1999 Settlement Agreement and then declare that the terms are being changed such that the utility will have no opportunity to receive any of the benefits of the Agreement. In Decision No. 62103, the Commission stated that "it is also not the Commission's intent to undermine the benefits the parties have bargained for". See Decision No. 62103 at 12.

RUCO, in similar fashion to the AECC, has misinterpreted the impact of the Track A order on the calculation of the standard offer generation service rate. The fact that generation assets have not been divested and will not be divested is not related to the manner in which the standard offer generation service rate is determined. If that were the case, the Commission would have expressly ordered TEP to change the methodology that it has been using from the market-based MGC to a cost-of- service calculation. In fact, just the opposite is true. After the Track A order

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was issued, the Commission re-affirmed the MGC in Decision No. 65751 when it authorized a modification to the MGC formula for TEP's use.[7]

D. TEP's Reply to Commission Staff's Request For Procedural Order and Response to TEP's Action For Declaratory Order.

Commission Staff also disputes that TEP's standard offer generation service rate is to be determined by the MGC after December 31, 2008. Commission Staff acknowledges that the 1999 Settlement Agreement does not contain any language that changes the manner for setting rates after December 31, 2008. [Staff Response at 2.] However, Staff assumes that the Commission did not intend to depart from the provisions of the Electric Competition Rules, which indicate that standard offer rates shall reflect the costs of providing the service. Commission Staff's argument ignores the reality that (i) the 1999 Settlement Agreement did change the manner in which TEP calculated its standard offer generation rate from cost-of-service based to market-based; (ii) the 1999 Settlement Agreement provides that its terms supersede conflicting provisions of the Electric Competition Rules (See 1999 Settlement Agreement at Section 14.3, and Decision No. 62103 at 12); and (iii) reliance on the Electric Competition Rules is, at best, uncertain given that Phelps Dodge has called into question the viability and enforceability of those Rules. What is certain is that neither Commission Staff nor any other Respondent can cite to any Commission action that expressly terminates TEP's calculation of its standard offer generation service rate using the MGC.

Commission Staff also leans upon the Track A order to argue that because the Commission prohibited the divestiture of generation assets, the standard offer generation service must be cost-of-service based. But, the language cited by Commission Staff in the Track A order [Decision No. 65154 at 22-25] says nothing about transitioning back to cost-of-service rates. To the contrary, the cited language is clear that TEP is entitled to the benefits it bargained for in the 1999 Settlement Agreement and that notwithstanding the cancellation of divestiture, all parties were to work together to move towards competition in a timely and meaningful fashion. [*Id.* at 23.] The

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[7] The Track A order was issued on September 10, 2002. Decision No. 65751 was issued six (6) months later, in March 2003. RUCO was a party to Decision No. 65751.

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Commission did not indicate that it was ordering a reversion back to cost-of-service based rates for standard offer generation service.

Finally, TEP supports the Commission Staff's request for an extension of the time periods governing TEP's pending rate proceeding, as evidenced by the Stipulation filed with the Commission in the 2004 Rate Review docket. TEP also renews its request that a procedural conference be held in the pending rate proceeding and an appropriate procedure for adjudication of the Motion for Declaratory Order be discussed and ordered.

V. CONCLUSION.

TEP's standard offer generation service rate is currently being determined by the MGC. No party has cited any language in any decision, order or rule that terminates that rate methodology at any time. Respondents' attempts to analogize or otherwise infer a termination date have failed on factual grounds. The reality is that absent any intervening Commission action, effective January 1, 2009, TEP's standard offer generation service rate will continue to be determined by the MGC without the mitigating effects of the Floating CTC.

TEP has proposed the concept of a modification to the 1999 Settlement Agreement that is designed to keep customer rates stable (and at 1994 levels), well into the future, while at the same time protecting the financial stability of TEP. TEP supports an extension of the deadlines in the pending 2004 Rate Review case. TEP requests that the procedure moving forward with the Motion for Declaratory Order be conducted in the context of the TEP rate filing, which contains appropriate and sufficient fair value data to support a forward-looking rate decision.

RESPECTFULLY SUBMITTED this 1st day of June 2005.

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EXHIBIT

1

A UniSource Energy Company

Duplicate Bill

Account:
Bill Date: 5-24-2005
Customer Name:
Service Address:
TUCSON, AZ

Previous Balance	Payments	+ Current Charges	= Current Balance
3.48 CR	114.87	118.35	0.00

DUE DATE	AMOUNT DUE
5-9-2005	$0.00

Payment: $114.87 on 4-5-2005- Thank you!

At home, at work and in the community...We're there when you need us.TM

Go paperless with TEP e-bill! Sign up today to receive, view and pay your TEP bill online at tep.com

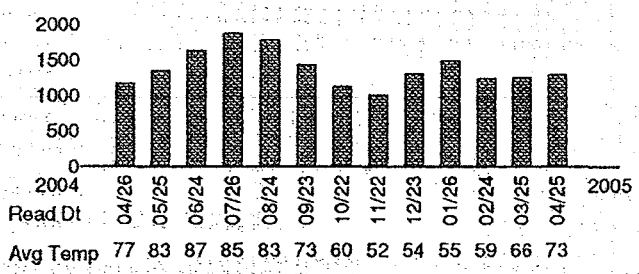
R01-Residential

Cost of Electric Service Used

COMPETITIVE SERVICES	
Generation of Electricity	70.91
Transmission & Ancillary	14.41
Billing	2.52
Meter Services	1.01
Meter Reading	0.80
The Above Competitive Charges Can Be Compared to Other Suppliers	
TEP DELIVERY SERVICES	
Customer Charge	0.62
Distribution Delivery	41.09
System Benefits	1.85
Environmental Portfolio Surcharge	0.35
Competition Transition Charge	26.44 CR
TAXES AND ASSESSMENTS	
ACC Assessment	0.19
RUCO Assessment	0.03
City Franchise Fee	2.71
State Sales Tax	6.16
City Sales Tax	2.14
Total Electric Service Charges	$118.35

Your average cost per day for this Bill was $3.82

Historical Usage (KWH)



Meter	Unit of Measure	Next Read Date	Current Read Date	Prior Read Date	Days	Current Reading	- Prior Reading	= Reading Difference	x Multiplier	= Usage
XH-44935	KWH	5-24	4-25	3-25	31	1490	1361	0129	10	1290

Para asistencia en Español, el número de teléfono se encuentra al reverso de esta pagina.

EXHIBIT

2

Schedule MGC-1
Tucson Electric Power Company
Market Generation Credit (MGC) Calculation

A UniSource Energy Company

Introduction

There are two purposes of the Market Generation Credit (MGC). The first purpose is to establish a price to which TEP's energy customers can compare to the prices of competitors. The second purpose is to enable the calculation of the variable or "floating" component of TEP's stranded cost recovery. Shown below are the terms of the MGC methodology per TEP's Settlement Agreement, Section 2.1(d), as amended March 20, 2003:

> The monthly MGC amount shall be calculated in advance and stated as both an on-peak value and an off-peak value. The monthly on-peak MGC component shall be equal to the Market Price multiplied by one plus the appropriate line loss (including unaccounted for energy ("UFE")) amount. The Market Price shall be equal to the Platts Long-Term Forward Assessment for the Palo Verde Forward price, except when adjusted for the variable cost of TEP's must-run generation. The Market Price shall be determined thirty (30) days prior to each calendar month using the average of the most recent three (3) business days of Platts Long-Term Forward Assessment for Palo Verde settlement prices. The off-peak MGC component shall be determined in the same manner as the on-peak component, except that the Platts Long-Term Forward Assessment for the Palo Verde Forward price will be adjusted by the ratio of off-peak to on-peak prices from the Dow Jones Palo Verde Index of the same month from the preceding year. The MGC shall be equal to the hours-weighted average of the on-peak and off-peak pricing components and shall reflect the cost of serving a one hundred percent (100%) load factor customer.

To reflect the cost of serving a 100% load factor customer, the actual MGC used for billing calculations will be a loss adjusted average price that is weighted by the ratio of on-peak and off-peak hours. This process is illustrated in equations 4 and 5 below and will be posted to TEP's website http://partners.tucsonelectric.com thirty (30) days prior to each calendar month. This composite price will be credited to all energy consumption, regardless of the time period in which it is consumed.

Calculations

Five steps are outlined below for the calculation of the MGC. None of the steps are excludable for any customer type. Acronyms are defined in the Glossary at the end of this document.

Schedule MGC-1
Tucson Electric Power Company
Market Generation Credit (MGC) Calculation

A UniSource Energy Company

1. Calculating the on-peak MGC

Thirty (30) days prior to each calendar estimation month, the Platts Long-Term Forward Assessment for Palo Verde Forward prices for the three (3) most recent business days are used. The simple average (or arithmetic mean) is calculated for these three (3) days for the estimation month.

$$MGC_{ON,i} = \frac{\sum (PLATTS)_i}{3} \qquad \text{(Equation 1)}$$

The calculation is illustrated in the table below.

Forward Prices per MWh	Apr-2002
3/1/2002	$25.50
2/28/2002	$25.50
2/27/2002	$24.75
Average	$25.25

2. Calculating the off-peak MGC

The off-peak MGC is determined by multiplying the on-peak MGC value by the off-peak price weighting factor (WEIGHT). The WEIGHT is equal to the simple average of all off-peak prices from the Dow Jones Palo Vérde Index in the same month of the previous year, divided by the simple average of all on-peak prices from the Dow Jones Palo Verde Index in the same month of the previous year. Off-peak, on-peak and holiday hours are defined by NERC in the estimation month.

$$MGC_{OFF,i} = MGC_{ON,i} * WEIGHT_i \qquad \text{(Equation 2)}$$

where

$$WEIGHT_i = \frac{DJPVI_{OFF,i}}{DJPVI_{ON,i}} \qquad \text{(Equation 3)}$$

3. Weighting the MGC for hours in the month

The on-peak and off-peak MGCs are combined to form an average MGC by computing a weighted average of the two time periods. This is done by multiplying the on-peak MGC by the percentage of on-peak hours in the same month of the previous year and then adding the product of the off-peak MGC and the percentage of off-peak hours in the same month of the previous year. Off-peak, on-peak and holiday hours are defined by NERC in the estimation month.

$$MGC_{WEIGHT,i} = MGC_{ON,i} * \left(\frac{ONHOURS}{ONHOURS + OFFHOURS} \right) + MGC_{OFF,i} * \left(\frac{OFFHOURS}{ONHOURS + OFFHOURS} \right)$$

(Equation 4)

4. Loss-adjusting the MGC

The average MGC must be adjusted for line losses. The appropriate line loss adjustment factor (LLAF) for a large industrial customer is 1.0515. For all other customers, the appropriate factor is 1.0919.

$$MGC_{LOSS,i} = MGC_{WEIGHT,i} * LLAF \qquad \text{(Equation 5)}$$

5. Adjusting the MGC for variable must-run

The MGC will be adjusted for variable must-run as defined in TEP's Stranded Cost Settlement Agreement and AISA protocols. Fifteen (15) days prior to each month, TEP forecasts a ratio of its variable must-run generation to retail system demand for the following month. The MGC is determined by adding the product of MGC_{LOSS} and one minus the ratio of variable must-run generation to total retail system demand to the product of $15/MWh and the variable must-run ratio.

$$MGC_i = \left[MGC_{LOSS,i} * (1 - VMR_i) \right] + (\$15 * VMR_i) \qquad \text{(Equation 6)}$$

This calculation produces the final value for the Market Generation Credit.

GLOSSARY

$DJPVI_{OFF}$	Simple average of off-peak prices on the Dow Jones Palo Verde Index.
$DJPVI_{ON}$	Simple average of on-peak prices on the Dow Jones Palo Verde Index.
Dow Jones Palo Verde Index	Daily calculation of actual firm on-peak and firm off-peak weighted average prices for electricity traded at Palo Verde, Arizona switchyard.
AISA	Arizona Independent Scheduling Administrator, a temporary entity, independent of transmission-owning organizations, intended to facilitate nondiscriminatory retail direct access using the transmission system in Arizona. Required by the Arizona Corporation Commission Retail Electric Competition Rules.
LLAF	Line-loss adjustment factor.
MGC	Market Generation Credit.
MGC_{OFF}	MGC_{ON} weighted by the ratio of off-peak to on-peak prices on the Dow Jones Palo Verde Index.
MGC_{ON}	Average of the Platts prices on days appropriate for the calculation of the MGC.
MGC_{LOSS}	MGC_{WEIGHT} adjusted for line losses (including unaccounted for energy) on TEP's generation and energy delivery systems.
MGC_{WEIGHT}	A weighted average of MGC_{ON} and MGC_{OFF} by ONHOURS and OFFHOURS.
Must-run Generation	The cost associated with the running of local generating units needed to maintain distribution system reliability and to meet load requirements in times of congestion on certain portions of the interconnected grid.
NERC	North American Electric Reliability Council. A voluntary not-for-profit organization established to promote bulk electric system reliability and security. Membership includes: investor-owned utilities; federal power agencies; rural electric cooperatives; state, municipal and provincial utilities; independent power producers; power marketers; and end-use customers.

Schedule MGC-1
Tucson Electric Power Company
Market Generation Credit (MGC) Calculation

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OFFHOURS	Number of total monthly off-peak hours as defined by NERC. Off-peak hours are hour ending 0100 – hour ending 0600 and hour ending 2300 – hour ending 2400, Monday through Saturday, Pacific Prevailing Time (PPT). All Sunday hours are considered off-peak. PPT is defined as the current clock time in the Pacific time zone.
ONHOURS	Number of total monthly on-peak hours as defined by NERC. On-peak hours are hour ending 0700 – hour ending 2200 Monday through Saturday, Pacific Prevailing Time (PPT). PPT is defined as the current clock time in the Pacific time zone.
PLATTS	A McGraw-Hill publication that provides an independent daily evaluation of on-peak Long Term Forward Assessment of market prices of electricity at the Palo Verde, Arizona switchyard. The forward product is "6 x 16," power is for 16 hours a day for six days a week (Monday through Saturday) for the delivery period, excluding NERC holidays.
Stranded Costs	The difference between revenues under competition and the costs of providing service, including the inherited fixed costs from the previous regulated market.
TEP	Tucson Electric Power Company, a subsidiary of UniSource Energy Corp.
TEP Settlement Agreement	An agreement between TEP, the Arizona Residential Utility Consumer Office, members of the Arizonans for Electric Choice and Competition, and Arizona Community Action Association regarding TEP's implementation of retail electric competition, implementation of unbundled tariffs, and recovery of stranded costs.
VMR	Ratio of variable must-run generation (MW) to total retail system demand (MW) in TEP's service territory.
WEIGHT	Ratio of off-peak to on-peak prices on the Dow Jones Palo Verde Index.