



BEFORE THE ARIZONA CORPORATE

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IN THE MATTER OF THE FILING BY TUCSON)
ELECTRIC POWER COMPANY TO AMEND)
DECISION NO. 62103.)

DOCKET NO. E-01933A-05-0650

**TUCSON ELECTRIC POWER
COMPANY'S REPLY IN SUPPORT
OF MOTION TO AMEND
DECISION NO. 62103**

Tucson Electric Power Company ("TEP" or the "Company"), through undersigned
counsel, respectfully submits this reply in further support of its Motion to Amend Decision No.
62103 as follows:

I. INTRODUCTION.

The Motion to Amend is in the public interest and should be granted. However, at this
point the Company is merely requesting that a procedural schedule be set for the filing of
additional testimony by all interested parties and for a hearing to be held in order to provide the
Commission with an evidentiary basis upon which to determine whether the Motion to Amend is
in the public interest.

It is indisputable that the 1999 Settlement Agreement was entered into to resolve issues
regarding TEP's transition from traditional cost of service regulation to a competitive marketplace
for generation service. [See 1999 Settlement Agreement at 1-3; Decision No. 62103 at 16-18.]
Similarly, there is no question that the 1999 Settlement Agreement has provided significant
benefits for TEP's customers. The Motion to Amend proposes to enhance and extend customer
benefits beyond the termination of the 1999 Settlement Agreement.

1 The Motion to Amend simply seeks to (i) clarify how generation rates will be determined
2 after the rate freeze ends on December 31, 2008; (ii) ensure that TEP's customers do not
3 experience a significant base rate increase on January 1, 2009; (iii) enhance the wholesale electric
4 generation market by excluding certain TEP generation assets from rate base; and (iv) protect TEP
5 customers from energy cost volatility by the implementation of an energy cost adjustment clause.
6 Individually and collectively, these components of the Motion to Amend deserve further
7 consideration by the Commission. To simply reject the Motion to Amend at this point, without
8 "an opportunity to be heard as upon a complaint" is contrary to the law and a disservice to TEP's
9 customers. *See* A.R.S. § 40-252.

10 For example, if the Motion to Amend were to be dismissed now (TEP's second attempt to
11 present these matters to the Commission) and the issues raised therein not resolved, the following
12 potential scenarios would face the Commission, TEP and its customers on January 1, 2009:

- 13 1. Customers would be charged market-based rates for generation. TEP projects that
14 this would result in a significant rate increase; or
- 15 2. Customers would be charged cost-of-service based rates for generation. TEP
16 projects that this would result in a significant increase; or
- 17 3. TEP and the Commission would be in litigation over the 1999 Settlement
18 Agreement and rates to be charged to customers.¹

19 It is not necessary that the Commission, TEP or its customers be subject to any of these
20 scenarios. By granting the Motion to Amend, the Commission can take affirmative action to
21 resolve the question of how rates will be determined after December 31, 2008, avoid rate increases
22 for TEP's customers, bolster wholesale electric generation and remove customer risk and exposure
23 to volatile energy costs. TEP respectfully submits that the public interest is best served by
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25 ¹ The Commission itself is a party to the Settlement Agreement. *See* Settlement Agreement § 13.1 and 13.3. In the
26 event that parties to the Settlement Agreement cannot agree upon the interpretation thereof, it would be left to the
27 Courts, rather than any one party to determine the proper interpretation. *See U. S. West Communications, Inc. v. Arizona Corp. Comm'n*, 185 Ariz. 277, 280, 915 P.2d 1232, 1235 (App. 1996)(because "interpreting the agreement is a question of law for the court and not a discretionary function constitutionally entrusted to the Commission, we owe no deference to the Commission's interpretation.")

1 amending Decision No. 62103 (and the terms of the 1999 Settlement Agreement) now to clarify
2 and amend the 1999 Settlement Agreement and provide TEP's customers with certainty as to the
3 future of their electric rates and charges.

4 **II. BACKGROUND.**

5 At the heart of the Motion to Amend is the question, "How will TEP's generation rate be
6 determined after December 31, 2008?" TEP has steadfastly maintained that the 1999 Settlement
7 Agreement is designed for generation rates to be market-based in 2009. In consideration for that,
8 TEP agreed to significant burdens, including a rate freeze and accelerated depreciation of its
9 assets. Parties to the Settlement Agreement are now indicating that they do not believe that
10 generation rates should be market-based. If the Commission will not permit TEP to charge
11 market-based generation rates in 2009, it should indicate so now and proceed to increase existing
12 rates to cover TEP's increased costs. But a better alternative is for the parties to work together to
13 find a solution they can all agree on. This is why TEP filed this Motion to Amend. This will
14 provide certainty for TEP and its customers in planning for the future. It would be inequitable for
15 the Commission to require TEP to incur all the burdens of the 1999 Settlement Agreement and
16 then refuse to grant TEP the intended benefit of market-based rates.

17 This is not the first time that TEP has attempted to present these matters to the
18 Commission. The same issues and proposed amendments were presented in TEP's Motion for a
19 Declaratory Order and Request for Procedural Conference (the "Motion for Declaratory Order")
20 filed on May 4, 2005 in Docket No. E-01933A-04-0408 (the "2004 Rate Review") and in the
21 generic restructuring dockets. After Staff and others filed oppositions to the Motion for
22 Declaratory Order, the Administrative Law Judge issued a procedural order that suggested TEP
23 consider reopening certain dockets pursuant to A.R.S. §40-252, given that the Motion for
24 Declaratory Order appeared to be a request to clarify Decision 62103 and the 1999 Settlement
25 Agreement. [See June 10, 2005 Procedural Order at 5.]

26 In response to the Procedural Order, TEP filed its Motion to Amend Decision No. 62103
27 pursuant to A.R.S. §40-252. The Residential Utility Consumer Office ("RUCO"), Arizonans for

1 Electric Choice and Competition, Phelps Dodge Mining Company, and ASARCO ("AECC"),
2 Southwest Energy Efficiency Project and Western Resource Advocates, Inc. ("SWEEP/WRA"),
3 and Staff all filed responses to the Motion to Amend. A procedural conference is scheduled for
4 October 24, 2005 for the purpose of oral argument on the Motion to Amend and procedural
5 guidelines should the Commission decide to proceed.

6 **III. OVERVIEW OF THE ARGUMENTS AND ISSUES.**

7 In opposing the Motion to Amend, Staff and others argue in varied degrees that the
8 Settlement Agreement does not authorize TEP to calculate its standard offer generation rate based
9 on the Market Generation Credit ("MGC") formula after 2008. In addition, Staff argues that
10 several events have occurred since the Commission approved the 1999 Settlement Agreement
11 which have either modified the terms of the original agreement or otherwise now preclude TEP
12 from offering market rates after 2008. According to Staff, these events include the Commission's
13 decisions in Decision No. 65154 ("Track A"), Decision No. 65753 ("Track B") and Decision No.
14 67744 (the "APS Rate Case") as well as the Arizona Court of Appeals' decision in *Phelps Dodge*
15 *Corp. v. Arizona Elec. Power Co-Op., Inc.* 207 Ariz. 95, 83 P.3d 573 (App. 2004).

16 These arguments overlook three basic facts: (1) the purpose and intent of the 1999
17 Settlement was to transition TEP into competition by utilizing market-based rates; (2) since the
18 Commission approved the 1999 Settlement Agreement in Decision No. 62103, TEP's standard
19 offer rate for generation service has been calculated by applying the MGC; and (3) nothing in the
20 Settlement Agreement can be read to state or even imply that the calculation of standard offer
21 generation rates under the MGC shall terminate and revert to cost of service after 2008².
22 Therefore, absent further Commission action, TEP will continue to calculate its standard offer
23 service generation rate by applying the MGC. Similarly, there is nothing in the Track A decision
24 or *Phelps Dodge* that precludes TEP from continuing to calculate its standard offer service
25 generation rate after 2008 under the existing MGC.

26 _____
27 ² Indeed, no one can validly claim that the intention and purpose of the 1999 Settlement Agreement and Decision
No. 62103 were to transition TEP to competition only until 2009, at which time TEP was to revert back to cost-based
regulation.

1 This open disagreement over the interpretation of the 1999 Settlement Agreement as well
2 as the relevance, if any, of the Track A decision and *Phelps Dodge* only serves to underscore the
3 need to immediately address and resolve the dispute over TEP's rate treatment after 2008. TEP
4 followed the 1999 Settlement Agreement's terms. Pursuant to the 1999 Settlement Agreement,
5 TEP has: (1) implemented two rate decreases; (2) maintained a rate moratorium through
6 December 31, 2008 (although rates could decrease); (3) unbundled its rates; (4) accelerated
7 depreciation of assets; (5) offset standard offer service generation by the amount of the Floating
8 Competition Transition Charge ("CTC") (in excess of \$1.3 billion); (6) opened its previously
9 exclusive CC&N territory to competitors; and (7) dismissed court appeals of Commission
10 decisions. Each of these actions provides direct benefits to TEP's customers, at TEP's expense.

11 TEP has taken each of these actions in good faith and in reliance upon the fact that its
12 standard offer generation rate would continue to be determined by the MGC after 2008. Although
13 there was and is no guarantee that TEP will be able to profitably earn a return through market-
14 based rates, it is the ability to charge market-based rates after 2008 that provides economic
15 symmetry to the 1999 Settlement Agreement. The opportunity to charge market-based rates was a
16 key incentive (and in fact, a quid pro quo) upon which TEP relied, in agreeing to take the actions
17 that have provided direct benefits for TEP's customers, at the utility's expense³. It would be
18 inequitable for the Commission – at this point in time, after TEP has provided all of the
19 enumerated benefits to customers – to reverse course and force TEP back to calculating its
20 standard offer generation rates on a traditional cost-of-service basis.

21 Simply put, the Commission needs to let TEP and its customers know where they stand.
22 TEP and its customers need to know if the Commission is going to (1) abide by the terms of the
23 1999 Settlement Agreement and allow TEP to continue to charge market-based rates after 2008;
24 (2) unilaterally modify the 1999 Settlement Agreement and require that TEP go back to
25 calculating its standard offer generation rates as a non-competitive service; or, (3) approve TEP's
26

27 ³ These actions include a rate freeze, which based upon the 2004 Rate Review filings, has resulted in TEP under earning approximately \$112 million, as well as the accelerated depreciation of TEP assets.

1 Motion to Amend. TEP and its customers deserve some degree of certainty as to the methodology
2 for calculating future rates.

3 **V. SUMMARY OF THE PARTIES' RESPONSES.**

4 **A. Summary of AECC's Response.**

5 AECC's Response to the Motion to Amend re-urges the arguments it made in its Motion to
6 Suspend. [See Motion to Suspend dated September 22, 2005.] According to AECC, TEP has
7 failed to comply with Section 13.2 of the Settlement Agreement which requires the parties make
8 good faith efforts to propose joint resolutions in addressing potential modifications to the
9 Settlement Agreement and Decision No. 62103. Thus, AECC contends that TEP should be
10 ordered to meet with AECC and other parties to seek joint proposals for amending Decision No.
11 62103." [AECC Response at 2.] AECC further asserts that "if a procedural schedule is
12 established prior to substantive discussions between the Settlement parties concerning potential
13 solutions to the issues raised by TEP, AECC's rights under the Settlement will be prejudiced."
14 [Id. at 3].

15 **B. Summary of SWEEP/WRA Response.**

16 In its Response, SWEEP/WRA requests that if the Commission is inclined to consider the
17 issues raised by TEP, that the Commission also consider demand side management ("DSM") and
18 renewable energy issues. [SWEEP/WRA Response at 2.] According to SWEEP/WRA, TEP's
19 Motion to Amend has many of the characteristics of a rate case and therefore the Commission
20 should allow for the consideration of rate related issues including DSM and renewable energy.
21 [Id.]

22 **C. Summary of RUCO's Response.**

23 In its Response, RUCO states that it "does not disagree with TEP's stated goal of
24 providing rate stability and predictability and protection from future volatile energy charges"
25 [RUCO Response at 4.] At the same time, RUCO contends that it is not necessary to amend
26 Decision No. 62103 to secure TEP's four proposed amendments. [Id.] According to RUCO,
27 "regardless of the merit of any of TEP's four proposals, there is no need to reopen Decision No.

1 62103 to adopt them.” [*Id.* at 8.]

2 With regard to TEP’s first proposed amendment of extending the existing TEP’s rate
3 freeze, RUCO contends that the Settlement Agreement and Decision No. 62103 are “silent” as to
4 what TEP’s generation service rates will be after December 31, 2008 except to indicate that
5 neither the fixed or floating CTC will be included in those rates. Therefore, according to RUCO,
6 the Commission is free to adopt whatever rates are appropriate once the rate freeze expires. [*Id.* at
7 5.]

8 In response to TEP’s second proposed amendment of retaining the current CTC
9 amortization schedule, RUCO argues the Settlement Agreement approved in Decision No. 62103
10 provides that the fixed CTC would be amortized over the period from 1999 to 2008. RUCO is not
11 aware of any party to the Settlement Agreement who has suggested that the amortization schedule
12 be modified. RUCO contends, therefore, there is no reason to modify Decision No. 62103. [*Id.* at
13 6.]

14 Finally, with regard to the proposed amendment for an adjustor mechanism to protect TEP
15 and its customers from energy market volatility beginning December 31, 2008, RUCO again
16 argues that nothing in the Settlement Agreement or Decision No. 62103 prevents the Commission
17 from adopting an adjustor mechanism if it deems an adjustor is appropriate. [*Id.* at 7.]

18 RUCO concludes by arguing that while it would not be necessary to amend Decision
19 62103 to extend the rate freeze or implement an adjustor mechanism, the Commission could only
20 adopt those proposals in conjunction with a finding of the fair value of TEP’s rate base. [*Id.* at 8.]

21 **D. Summary of Staff’s Response.**

22 In its Response, Commission Staff makes the preliminary argument that TEP’s Motion to
23 Amend should be dismissed out-of-hand based upon three alleged deficiencies: (1) TEP has failed
24 to satisfy the filing requirements of set forth A.A.C. R14-2-103; (2) TEP’s Motion is premature;
25 and (3) TEP’s Motion fails to sufficiently support and describe the relief it seeks. Staff then goes
26 on to contend that if the Commission elects to consider TEP’s Motion on the merits, that the
27 motion should be denied because Decision 62103 does not entitle TEP to charge market-based

1 rates, and TEP's alleged market-based rate authority is inconsistent with the Track A order and the
2 Arizona Court of Appeals' decision in *Phelps Dodge*. [Staff Response at 1.]

3 Staff initially argues that the Motion to Amend essentially seeks rate relief because it seeks
4 to establish new rates, requests the establishment of an adjustment mechanism, and rate base
5 determinations. [*Id.* at 2.] On this basis, Staff contends that TEP's Motion to Amend must satisfy
6 the rate case filing requirements of A.A.C. R14-2-103, and because it does not, the Motion should
7 be dismissed. [*Id.*]

8 Staff then goes on to argue that even if TEP were to supplement its Motion to Amend to
9 comply with A.A.C. R14-2-103, TEP must base its rate filing on "an appropriate test year."
10 According to Staff, using a June 30, 2007 test year is an appropriate basis for determining post-
11 2008 rates and absent 2007 test year data, TEP's Motion to Amend is premature. [*Id.* at 3.]

12 Staff completes its preliminary attack on the Motion to Amend by complaining that the
13 Motion should be dismissed because it is too vague and incomplete. In making this argument,
14 Staff contends that the motion fails to identify all of the specific generation assets that TEP
15 proposes to exclude from its rate base and is "unclear" about the exact details for the proxy that
16 will be used for a energy cost adjustment clause under its proposed amendments. [*Id.* at 3.]
17 According to Staff, "TEP appears to view its Motion in this matter more as an invitation to
18 negotiate than as an application to seek specific relief" and this "lack of specificity" in TEP's
19 Motion requires that it be dismissed.

20 Beyond its preliminary arguments for dismissal, Staff argues that even if TEP were to
21 remedy the alleged deficiencies underlying its Motion to Amend, Staff disagrees with TEP's
22 "foundational premise" that it is entitled to charge market-based generation rates after 2008
23 because (1) Decision No. 62103 does not establish that TEP's rates shall be market-based; (2) the
24 Commission's Track A order is inconsistent with TEP's assertion that it is entitled to market-
25 based rates; and (3) TEP's concept of market-based rates is inconsistent with the requirements of
26 *Phelps Dodge*.

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1 Staff initially attacks the “foundational premise” of the Motion to Amend by arguing that
2 the 1999 Settlement Agreement is silent as to how the Commission was to set standard offer
3 generation rates after 2008. [*Id.* at 6.] Given this alleged silence in the Settlement Agreement,
4 Staff contends that no reason exists to presume that the Commission intended to depart from the
5 provisions of the Electric Competition Rules, which classify “standard offer service” as a non-
6 competitive service and provide that standard offer rates “shall reflect the costs of providing the
7 service.” [*Id.*]

8 Staff goes on to argue that even if TEP’s description of the 1999 Settlement Agreement’s
9 foundational premise were undisputed, it has been “erased” by the Track A order. [*Id.* at 5.]
10 According to Staff, the question of how TEP’s rates will be set after 2008 has been answered – the
11 Track A order contemplates that TEP will retain its generation assets and that those assets will be
12 dedicated to serving TEP’s customers on a traditional cost-of-service basis. [*Id.*]

13 Finally, Staff urges that beyond the Track A order, the concept of market-based rates was
14 questioned by the Arizona Court of Appeals in *Phelps Dodge* where the Court stated that the
15 Commission may not delegate its rate setting function to the market, but must ensure that utility
16 rates are just and reasonable. [*Id.*] According to Staff, the market-based rate authority that TEP
17 seeks is unlikely to satisfy the requirements of *Phelps Dodge* and therefore is unlikely to result in
18 reasonable rates.

19 **V. MISCONCEPTIONS CONCERNING 1999 SETTLEMENT.**

20 The Responses outlined above demonstrate that some of the respondents have a general
21 misunderstanding as to the calculation of TEP’s standard offer service generation rate, the MGC
22 and the CTC. In support of the Motion to Amend, TEP provides the following overview of these
23 three components of the 1999 Settlement Agreement before specifying the failings of the
24 individual responses.

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

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

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

11 A TEP customer's monthly bill now lists each of the unbundled services, categorized in
12 three main groups: Competitive Services, TEP Delivery Services, and Taxes and Assessments.
13 The generation of electricity is classified as a "Competitive Service." The components and format
14 of TEP's monthly customer bills were submitted to Staff for approval prior to distribution to
15 customers. Further, these billing components correspond to the Commission's Rules, which
16 require that generation service be listed as a Competitive Service. A.A.C. R14-2-1612.O. A copy
17 of a sample TEP customer bill listing unbundled services is attached hereto as Exhibit "1".

18 In order for a customer to consider a competitive energy provider, the customer must be
19 able to compare TEP's price with a competitor's offering. The price to compare is identified as
20 "Generation of Electricity" on the TEP bill, under the category of Competitive Services. This
21 price will reflect the seasonal nature of the market price of electricity. The price of the generation
22 of electricity is determined by applying the MGC. The MGC that is used to determine TEP's
23 price for standard offer generation was agreed to in the 1999 Settlement Agreement and approved
24 by the Commission in Decision No. 62103.⁴

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⁴ See Exhibit 1 at "Generation of Electricity."

1 **B. The MGC.**

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

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

8 The MGC incorporates the Dow Jones Palo Verde Index for electric generation prices. A
9 copy of TEP Tariff No. MGC-1 is attached hereto as Exhibit "2".

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

15 Consequently, absent further Commission action, TEP will continue to calculate its
16 standard offer service generation rate by applying the MGC. Denial of the Motion to Amend or
17 inaction by the Commission will have the effect of assuring that TEP's standard offer service
18 generation rate will be calculated by applying the MGC after December 31, 2008.

19 **C. The Floating CTC.**

20 The Floating CTC is a temporary mechanism that was introduced in the 1999 Settlement
21 Agreement (and authorized by the Commission). TEP applies the Floating CTC to its customers'
22 bills (as either a positive or negative amount) to assure that customers do not pay more than the
23 \$.08/kwh rate set forth in Decision No. 62103 for electric service during the transition period to
24 competition. For example, if the standard offer generation service rate, as calculated by the MGC,
25 (hereafter the "MGC rate") would cause the overall rate to be higher than \$.08/kwh, then the

26 _____
27 ⁵ The MGC was modified by the Commission in Decision No. 65751. This modification was made under A.R.S. §
40-252 to clarify the Settlement Agreement due to changed circumstances. Here, the Commission should likewise
clarify the Settlement Agreement under A.R.S. § 40-252.

1 Floating CTC would be applied as a credit on the customer's bill to bring the MGC rate down to
2 the \$.08/kwh rate. [See e.g. Exhibit 1 at "Competition Transition Charge".]

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

10 The responses filed by the parties illustrate their misconceptions concerning the 1999
11 Settlement and the need for an immediate resolution of the parties' disagreement concerning
12 whether TEP will continue to calculate its standard offer generation rate based upon the MGC as
13 contemplated by the Settlement or whether the Commission will seek to have TEP calculate its
14 standard offer generation rate under some other methodology.

15 **VI. TEP'S REPLY TO THE PARTIES' RESPONSES.**

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

17 In responding to the Motion to Amend, AECC backed away from many of substantive
18 arguments it raised in opposition to the Motion for Declaratory Order. At this point, AECC
19 appears content to simply argue that it wants everything put on hold while it discusses the issues
20 raised in the Motion to Amend. [See AECC Motion to Suspend and AECC Response.] As TEP
21 explained in its response to AECC's Motion to Suspend, there is no need to suspend proceedings
22 on the Motion to Amend to foster discussions among the signatories to the 1999 Settlement
23 Agreement. [See TEP Response in Opposition to Motion to Suspend.]

24 AECC has been well aware of the issues and amendments proposed in TEP's Motion to
25 Amend since June 1, 2005 when TEP filed its Motion for Declaratory Order in the 2004 Rate
26 Review. AECC responded to TEP's Motion for Declaratory Order and had ample time to meet
27 and confer with TEP over the issues presented in that Motion. To the extent that AECC wants to

1 discuss the same issues now that they are raised in the Motion to Amend, TEP is ready and willing
2 to have those discussions with AECC. To the extent AECC needs additional time to determine its
3 position on the proposed amendments, it can do so during the course of this docket.

4 Further, nothing in the 1999 Settlement Agreement requires that signatories to the
5 Agreement reach a resolution on modification of terms before coming to the Commission for
6 approval. The Motion to Amend presents AECC and other interested parties with the framework
7 in which to enter into discussions with TEP to reach a resolution of the current dispute over TEP's
8 right to charge market-based rates after 2008.

9 **B. TEP's Reply to the SWEEP/WRA Response.**

10 As TEP indicated at the July 6, 2005 procedural conference in the Rate Review docket, it
11 is willing to consider certain DSM-related issues in this docket. Such issues potentially could be
12 included as part of the amendments to Decision No. 62103 and the 1999 Settlement Agreement
13 that would be in the public interest.

14 **C. TEP's Reply to RUCO's Response.**

15 RUCO does not disagree with TEP's stated goal of providing rate stability and
16 predictability and protection from future volatile energy charges. [RUCO Response at 4.] At the
17 same time, RUCO argues that it is not necessary for TEP to amend Decision No. 62103 to secure
18 its proposed rate freeze and related amendments because the 1999 Settlement Agreement and
19 Decision No. 62103 are silent as to what TEP's generation service rates will be after 2008. [*Id.* at
20 5.] Thus, according to RUCO, the Commission is free to adopt whatever rates are appropriate
21 when the rate freeze expires in 2008, assuming the Commission makes a finding of TEP's fair
22 value at the time the Commission establishes rates. [*Id.* at 4.]

23 As indicated above, the obvious problem with RUCO's argument is that TEP and its
24 customers need certainty as to future rates and waiting until 2009 to decide what rates are
25 "appropriate" is not in the public interest. TEP believes that this docket is the appropriate place for
26 parties to discuss any issues regarding how rates will be determined. Regarding RUCO's
27 substantive arguments, TEP replies as follows:

1 **1. RUCO’s “silence” argument fails.**

2 RUCO urges that no amendment is required to impose a rate freeze or implement an
3 adjustor mechanism after 2008, as proposed by TEP, because “nothing in the Settlement
4 Agreement or Decision 62103 fixes rates for any period after December 31, 2008.” [*Id.* at 7.] In
5 making this argument, RUCO acknowledges that presently the MGC is currently being used to set
6 standard offer rates, but it argues that the MGC “has no particular relevance after termination of
7 the floating CTC at the end of 2008.” [*Id.* at 5.] RUCO misunderstands the MGC’s purpose.
8 RUCO apparently believes that the only purpose of the MGC under the 1999 Settlement
9 Agreement is as a mechanism to determine the floating CTC. [*Id.* at 4.] But, as previously noted,
10 the MGC has at least two purposes. One is to establish a price to which TEP’s customers can
11 compare the prices of competitors. Another purpose is to enable the calculation of the variable or
12 “floating” component of TEP’s stranded cost recovery. [*See* Exhibit 2 hereto, “Tariff MGC-1”.]

13 Thus, even when the CTC goes away, at a minimum, the MGC is necessary to set the price
14 against which TEP’s customers can compare the prices of TEP’s competitors. If the Commission
15 were to eliminate a market-based price for TEP’s standard offer service generation, as proposed by
16 RUCO, it would effectively preclude any potential for electric competition. No party has
17 suggested that the Commission should take such a step. And although RUCO states that “there is
18 nothing in the 1999 Settlement Agreement that suggests that, after 2008, the MGC would still be
19 used to set the standard offer price of electricity,” [*Id.* at 4] there is nothing in the 1999 Settlement
20 Agreement that terminates the MGC as the means to determine TEP’s standard offer service
21 generation rate.

22 The reality is that the existing MGC will remain in effect absent some action by the
23 Commission.

24 **2. RUCO’s “fair value finding” argument fails.**

25 RUCO argues that the rate freeze and adjustor proposed by TEP violate the fair value
26 requirement. [*Id.* at 8.] TEP acknowledges that the Commission must consider fair value in
27 setting rates, but here, TEP’s proposals are based on the extensive fair value information provided

1 in the 2004 Rate Review.⁶ RUCO's argument that this information will be out-of-date by 2009
2 misses the mark. Rate orders remain in effect until changed. Thus, they typically last a number of
3 years and in some cases many years. The rates approved in such orders do not become invalid
4 simply because the test year was long ago. The test years in such orders were reasonably current
5 when the orders were entered. In this case, the information in the rate review docket is reasonably
6 current for the purposes of an order entered now. There is a dispute now. It should be settled
7 now.

8 **D. TEP's Reply to Commission Staff's Response.**

9 Staff's response reveals that it has missed the ultimate purpose of this docket – to resolve
10 the dispute over the provisions of the 1999 Settlement Agreement and to avoid undesirable
11 outcomes in 2009. Although Staff acknowledges that there is a dispute over TEP's post-2008
12 generation rates, it seeks to perpetuate the debate rather than to resolve the issue.

13 **1. Staff's Preliminary Arguments.**

14 **(i) Rate case arguments fail.**

15 Staff argues that TEP's Motion is incomplete because it does not include the full rate case
16 information required by A.A.C. R14-2-103 (Rule 103). [Staff Response at 1-2.] Staff also argues
17 that the Motion seeks relief normally accomplished in a rate case. [*Id.*] In making this argument,
18 Staff recognizes the obvious inconsistency of its position. [*Id.* at 2.] TEP first attempted to raise
19 the issue concerning post-2008 rates and the parties' dispute over future rates in the 2004 Rate
20 Review. Staff opposed TEP's motion at that time arguing that the issues were not sufficiently
21 related and that TEP should seek such relief in this or other dockets. Now that TEP has filed its
22 Motion to Amend, Staff cannot argue that the Motion cannot be considered because the necessary
23 rate information was left behind in the 2004 Rate Review. Simply put, Staff cannot have it both
24 ways.

25 Beyond the glaring inconsistencies, Staff's rate case argument is flawed. A rate case is not
26 required to implement any of the items that TEP requests. TEP's first proposal is to extend the

27 _____
⁶ Docket No. E-01933A-04-0408.

1 current rate freeze. This simply keeps current rates in effect. Since rates are not changed, a rate
2 case is not needed. TEP's second proposal is to retain the current CTC amortization schedule.
3 This schedule was set in Decision No. 62103. Again, since rates are not changed, a rate case is not
4 required to re-affirm this schedule. TEP's third proposal is to agree not to seek rate base treatment
5 for certain generation assets. This proposal does not result in any present change in rates, and any
6 future rate effects will not take effect until after a future rate case. TEP's fourth proposal is to
7 establish an adjustor mechanism to protect both customers and itself from energy market
8 volatility. Staff correctly notes that adjustor mechanisms are ordinarily *established* in a rate case.
9 But here, TEP already has an established right to charge market-based generation rates under the
10 1999 Settlement Agreement and Decision No. 62103. TEP's proposal does not *establish* this
11 right, it sharply *limits* it in order to protect consumers. Therefore, no rate case is required⁷.

12 Staff next argues that even if TEP supplemented its Motion to Amend with the Rule 103
13 schedules from the 2004 Rate Review, the information that TEP provided is based upon an
14 inappropriate test year, citing A.A.C. R14-2-103.A.3.p. [*Id.* at 2.] This rule states that the end of
15 the test year "shall be the most recent practical date available prior to the filing." Staff does not
16 contend – nor could it – that the information it seeks (a test year ending June 30, 2007) was
17 available prior to the filing of TEP's Motion. TEP's Motion thus complies with this rule, to the
18 extent that it is applicable.

19 Further, Staff already reviewed and approved the test year TEP used in the 2004 Rate
20 Review. TEP's Application in the Rate Review docket noted the possibility of disputes over the
21 meaning of the 1999 Settlement Agreement and Decision No. 62103 and specifically reserved the
22 right to amend or revise TEP's requests if such disputes came to pass. [Application, at 5.] Staff
23 reviewed the application (including this reservation) and associated schedules and ruled that they
24 were sufficient. [See Staff Sufficiency Letter, dated October 15, 2004.] A sufficiency finding
25

26 ⁷ TEP submitted a full set of Rule 103 schedules in the 2004 Rate Review, just as in a normal rate case. Staff and
27 other parties reviewed this information, just as in a normal rate case. Thus, even if rate case procedures are
applicable, the Rule 103 schedules filed in connection with TEP's 2004 Rate Review can be considered and made a
part of this docket. See A.A.C R14-3-109.

1 determines that the filing meets the Commission's filing requirements. A.A.C. R14-2-103.B.7.
2 This includes the test year requirement. Having already approved the test year, Staff cannot now
3 object that the test year is incorrect.

4 Finally, Staff's (and RUCO's) argument that this information will be out-of-date by 2009
5 simply misses the mark. It is not wise to wait until the last minute to resolve difficult, important
6 and complicated issues. There is a dispute now. It should be settled now. Any final order issued
7 in this docket would be based on a reasonably current test year. Rate orders often have provisions
8 that do not take effect until the future. For example, the recent AEPCO and Southwest
9 Transmission rate orders approved a series of step increases that take effect over the next few
10 years. [See Decision Nos. 68071 and 68072.]

11 **(ii) TEP's Motion provides sufficient detail to begin this proceeding.**

12 Staff's argument that TEP's Motion to Amend lacks sufficient detail similarly has no
13 merit. TEP's Motion seeks relief under A.R.S. § 40-252. This law allows amendment of prior
14 orders after the utility has an "opportunity to be heard as upon a complaint." A complaint hearing
15 begins with the filing of a "petition or complaint." A.R.S. § 40-246(A). Under Arizona law, a
16 complaint need only provide a "short and plain statement of the claim." Ariz.R.Civ. P.8(a)(2); See
17 also A.A.C. R14-3-103(A)(incorporating by reference Arizona Rules of Civil Procedure).
18 Therefore, "extensive factual recitations are not required." *Anserv Ins. Services, Inc. v. Albrecht*,
19 192 Ariz. 48, 49 ¶ 5, 960 P.2d 1159, 1160 (1998). This is because Arizona is a "notice pleading
20 state". *Id.* Here, TEP's pleading gave notice to the parties of the issues it sought to raise and the
21 reasons TEP's proposals should be adopted. As this case progresses, further details will be
22 developed – either in pre-filed testimony, or in a settlement process. TEP agrees that if pre-filed
23 testimony is scheduled, it should go first so as to provide further details. Presenting a mass of
24 details now would only serve to obscure the decision that is currently before the Commission –
25 whether and how to proceed with this docket. Further, details would likely serve to harden the
26 parties' positions, thereby reducing the chance of settlement.

1 Staff accuses TEP of issuing “an invitation to negotiate rather than... an application for
2 specific relief.” [*Id.* at 4.] As explained above, TEP’s Motion is specific enough to satisfy notice
3 pleading requirements. As to inviting negotiation, TEP pleads guilty, as TEP believes that
4 negotiation is the best way to solve the difficult, important and complex issues presented by the
5 parties’ current disagreements over the meaning of the 1999 Settlement Agreement. Whether or
6 not resolved by negotiation, these disputes should be defused now, rather than being allowed to
7 blow up later.

8 Finally – and most importantly – TEP’s Motion provides more than enough detail to allow
9 the Commission to determine the proper procedure to evaluate whether it is in the public interest
10 to amend Decision No. 62103. Indeed, TEP has met with representatives of Staff three times and
11 responded to data requests to discuss the impending dilemma, the need for a timely amendment of
12 Decision No. 62103 and TEP’s desire to avoid undesirable results after 2008. Staff’s vagueness
13 arguments are simply an excuse to avoid dealing with this issue now.

14 **2. Staff’s Substantive Arguments.**

15 TEP disagrees with Staff’s substantive arguments concerning the interpretation of the 1999
16 Settlement Agreement. Again, that dispute highlights the need for a proceeding to determine what
17 amendments are in the public interest.

18 **(i) The 1999 Settlement Agreement is not silent.**

19 Staff disputes that TEP’s standard offer generation rate is to be determined by the MGC
20 after December 31, 2008, contending that the 1999 Settlement Agreement is silent on how rates
21 are to be determined after 2008. [*Id.* at 2.] Staff’s argument ignores the reality that (1) the 1999
22 Settlement Agreement did change the manner in which TEP calculated its standard offer
23 generation rate from cost-of-service based to market-based; (2) TEP has been abiding by the terms
24 of the 1999 Settlement Agreement by calculating its standard offer rates under the MGC formula
25 with the floating CTC; and (3) nothing in the 1999 Settlement Agreement provides that market-
26 based rates prescribed by the Agreement somehow expire with the floating CTC.

27 Simply put, the 1999 Settlement Agreement was intended to transition TEP to market-

1 based rates. Nothing in the 1999 Settlement Agreement provides that the calculation of standard
2 offer generation rates under the MGC shall terminate at the end of 2008 with the floating CTC.
3 Nor does anything in the Agreement provide that TEP shall immediately return to cost-of-service
4 based rates. The parties to the 1999 Settlement most certainly had no such intent or expectation,
5 for if they had, the Settlement Agreement would have contained such a provision. Here, silence
6 does not support Staff. Silence as to post 2008 rates establishes that rates will continue to be
7 calculated under the MGC.

8 **(ii) The Track A Order Does Not Support Staff.**

9 Staff also attempts to lean on the Track A order to argue that because the Commission
10 prohibited the divestiture of generation assets, the standard offer generation rate must be based on
11 cost-of-service. But the language cited by Staff in the Track A order [Decision No. 65154 at 22-
12 25] says nothing about transitioning back to cost-of-service rates. To the contrary, the cited
13 language is clear that (1) TEP is entitled to the benefits it bargained for in the 1999 Settlement
14 Agreement and (2) notwithstanding the cancellation of divestiture, all parties were to work
15 together to move towards competition in a timely and meaningful fashion. [*Id.* at 23.] The
16 Commission did not indicate that it was ordering a reversion back to cost-of-service based rates
17 for standard offer generation.

18 **(iii) *Phelps Dodge* does not prohibit MGC rates.**

19 Commission Staff's final stab at TEP's right to charge market-based rates after 2008 is its
20 contention that calculating standard offer generation rates under the MGC would amount to an
21 impermissible delegation of ratemaking power to the market under *Phelps Dodge*. [*Id.* at 6.]. Staff
22 misreads *Phelps Dodge*. The *Phelps Dodge* case concerned a Commission rule that purported to
23 declare all market-based rates for competitive services just and reasonable. See A.A.C. R14-2-
24 1611(A). According to the Court of Appeals, this rule violated the Arizona Constitution's
25 command that fair value must be considered. *Id.*, 207 Ariz. at 108; 83 P.3d at 586. It also violated
26 the requirement that the Commission, not the market, set rates. *Id.* at ¶ 36.

1 The *Phelps Dodge* decision did not, however, declare that all market-based rates are
2 invalid. Indeed, the Court stated that “assuming that the Commission establishes a range of rates
3 that is ‘just and reasonable,’ the Commission does not violate Article 15, Section 3 by permitting
4 competitive market forces to set specific rates within that approved range.” *Id.*, 207 Ariz. at 109 ¶
5 44, 83 P.3d at 587. In setting such a range of rates, the ACC has “broad discretion” as long as it
6 considers fair value. *Id.*, 207 Ariz. at 106, 83 P.3d at 584.

7 With respect to the 1999 Settlement Agreement and the rate treatment therein – including
8 the adoption of the MGC – the Commission has already satisfied any applicable requirements of
9 *Phelps Dodge*. First, the Commission clearly considered fair value. It used the then-recent fair
10 value finding in Decision No. 59594 (March 29, 1996) for its financial analysis, ruling that “no
11 additional financial analysis is legally necessary to justify unbundling of TEP’s current rate
12 levels.” Decision No. 62103 at 5. The Commission also did not leave it to the market alone to
13 determine rates. Instead, it ordered a series of agreed upon rate reductions. [*Id.* at 4.] Further, at
14 first, market forces are only considered as part of the floating CTC. [*Id.*] Even after 2008, only a
15 defined portion (the generation portion) of the total rate is market-based. Transmission and
16 distribution remain priced at fully regulated cost-of-service rates determined in a full rate case.
17 *Phelps Dodge*, 207 Ariz. at 101-102, 83 P.3d at 579-80 (describing competition rules, citing
18 A.A.C. R14-2-1606). By providing for an extended phase-in, and then limiting market forces to
19 only a part of the customer’s overall rate, the Commission remained firmly in control of the rate
20 setting process. It has not abdicated its powers to the market. Hence, the Settlement Agreement
21 does not violate *Phelps Dodge*.

22 This conclusion is reinforced by the Court of Appeal’s subsequent analysis of *Phelps*
23 *Dodge* in *Grand Canyon Trust v. Arizona Corp. Comm’n*, 107 P.3d 356, 365 107 P.3d 356 (Ariz.
24 App. 2005). The court explained that in *Phelps Dodge* it found “the determination of just and
25 reasonable rates need not be totally separated from market forces.” *Id.* at fn.12. The court went
26 on to quote *Phelps Dodge*, “the Commission may be influenced by market forces, in determining
27 what rates are ‘just and reasonable’ [but it] may not abdicate its constitutional responsibility to set

1 just and reasonable rates by allowing market forces alone to do so.” *Id.*

2 *Phelps Dodge* is based on the Arizona Supreme Court’s decision in *U.S. West*
3 *Communications, Inc. v. Arizona Corp. Comm’n*, 201 Ariz. 242, 34 P.3d 351 (2001)(“*U.S. West*
4 *II*”). *U.S. West II* definitively states the law in Arizona regarding the use of market rates – that
5 market rates can be used as long as the ACC considers fair value. In *U.S. West II*, the court noted
6 that “while the constitution clearly requires the Arizona Corporation Commission to perform a fair
7 value determination, only our jurisprudence dictates that this finding be plugged into a rigid
8 formula as part of the rate-setting process.” *Id.*, 201 Ariz. at 245-46 ¶ 17, 34 P.2d at 354-55. The
9 court held that its cases requiring use of the rigid formula were “inappropriate for application in a
10 competitive environment.” *Id.* at ¶ 19. Where there is competition, “there is no reason to rigidly
11 like the fair value determination to the establishment of rates.” *Id.* Instead, the ACC has “broad
12 discretion” to consider how to use fair value information. *Id.* at ¶ 21. The court explained that fair
13 value information should be considered to avoid “harsh extremes of the rate spectrum”. Here, by
14 limiting market forces to only the generation portion (at a defined market proxy) of the customer’s
15 bills, the Commission has effectively sheltered customers from the harsh extremes.

16 Further, even under the old “rigid formula,” market forces could be used to set part of a
17 customer’s rate, using an adjustor clause. Indeed, other electric utilities, like APS and AEPCO,
18 have adjustor clauses that cover the cost of generation purchased from other utilities, as well as the
19 fuel costs of their own generation. If market-based rates in adjustors can be used to cover
20 generation costs under the old “rigid formula,” market-based rates can certainly be used to cover
21 generation costs under competition as well.

22 Moreover, there is no doubt that the “rigid formula” does not apply here. In the electric
23 competition rules, the Commission determined that generation is competitive. *See* A.A.C. R14-2-
24 1601(7); *see also* A.A.C. R14-2-1612(O)(1)(a)(listing generation as a competitive service). The
25 Commission also acknowledged the competitive nature of generation in its order approving the
26 Settlement Agreement, stating that “[w]e believe the Settlement will result in an orderly process
27 that will result in small rate reductions during the transition period to a competitive generation

1 market.” See Decision No. 62103 at 17. Because generation is competitive, market rates are
2 permissible as long as the ACC considers fair value. *U.S. West II, supra*.

3 Lastly, any fair value challenge to the Commission’s order approving the Settlement
4 Agreement is far too late. Decision No. 62103 was entered in 1999. The time to challenge it is
5 long past. Arizona law provides that “in all collateral actions or proceedings, the orders and
6 decisions of the commission which have become final shall be conclusive.” A.R.S. § 40-254.
7 Further, except in a timely appeal, “no court of this state shall have jurisdiction to enjoin ... or
8 review” a Commission order. A.R.S. §§ 40-254(F); 40-254.01(F).

9 **VII. CONCLUSION.**

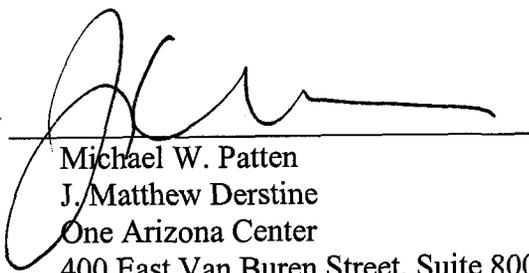
10 TEP’s standard offer generation rate is currently being determined by the MGC. No party
11 has cited any language in any decision, order or rule that terminates that rate methodology at any
12 time. Respondents’ attempts to analogize or otherwise infer a termination date fail on factual
13 grounds. The reality is that absent any intervening Commission action, effective January 1, 2009,
14 TEP’s standard offer generation rate will continue to be determined by the MGC without the
15 mitigating effects of the Floating CTC. In short, absent some intervening action by the
16 Commission, TEP’s generation rates after 2008 will be based on the MCG.

17 If the Commission is motivated to chart a course other than the one prescribed by the 1999
18 Settlement Agreement, now is the time to set a proceeding to determine what amendments to
19 Decision No. 62103 are in the public interest to provide predictability for both TEP and its
20 customers in a timely manner.

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1 RESPECTFULLY SUBMITTED this 21st day of October 2005.

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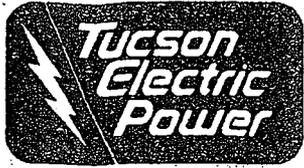
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16 By *Mary Ippolito*
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EXHIBIT

1



A UniSource Energy Company

Duplicate Bill

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

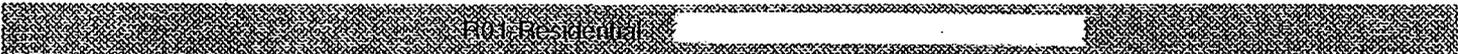
Previous Balance	Payment	Electric Charges	Current Balance
3.48 CR	114.87	118.35	0.00

DUPLICATE	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.™

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



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

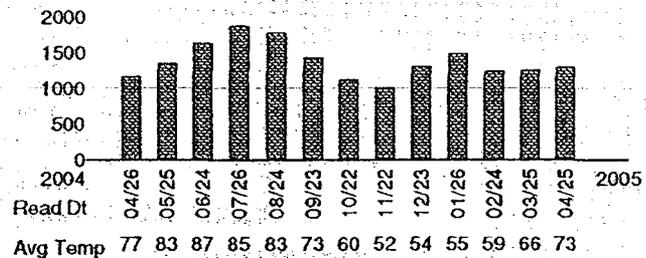
Customer Charge	0.62
Distribution Delivery	41.09
System Benefits	1.85
Environmental Portfolio Surcharge	0.35
Competition Transition Charge	26.44 CR

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

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.

Filed By: Steven J. Glaser
Title: Senior Vice President and COO/UDC
District: Entire Electric Service Area

Tariff No.: MGC-1
Effective: March 20, 2003
Page No.: 1 of 5



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.

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

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 Verde 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.

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

where

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

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Tariff No.: MGC-1
 Effective: March 20, 2003
 Page No.: 2 of 5



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

A UniSource Energy Company

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.

$$MGC_{LOSS,i} = MGC_{WEIGHT,i} * LLAF$$

(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.

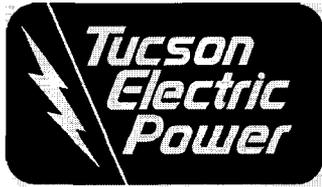
$$MGC_i = [MGC_{LOSS,i} * (1 - VMR_i)] + (\$15 * VMR_i)$$

(Equation 6)

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

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Tariff No.: MGC-1
Effective: March 20, 2003
Page No.: 3 of 5



A UniSource Energy Company

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

GLOSSARY

DJPV_{OFF}	Simple average of off-peak prices on the Dow Jones Palo Verde Index.
DJPV_{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.

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Tariff No.: MGC-1
Effective: March 20, 2003
Page No.: 4 of 5



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

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.

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Page No.: 5 of 5