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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING ELECTRIC RESTRUCTURING ISSUES.	Docket No. E-00000A-02-0051
IN THE MATTER OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. 4-14-2-1606	Docket No. E-01345A-01-0822
IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR	Docket No. E-00000A-01-0630
IN THE MATTER OF TUCSON ELECTRIC COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC POWER COMPETITION RULES COMPLIANCE DATES	Docket No. E-01933A-98-0471
ISSUES IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION RULES COMPLIANCE DATES	Docket No. E01933A-02-0069

INITIAL TESTIMONY OF JAMES S. PIGNATELLI

TUCSON ELECTRIC POWER COMPANY

TRACK A ISSUES

Arizona Corporation Commission
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May 29, 2002

INITIAL TESTIMONY OF JAMES S. PIGNATELLI
TRACK A ISSUES
May 29, 2002

I. INTRODUCTION.

Q. Please state your name and business address.

A. My name is James S. Pignatelli. My business address is One South Church Avenue, Tucson, Arizona 85701.

Q. What is your position with Tucson Electric Power Company ("TEP")?

A: I am Chairman of the Board, President and Chief Executive Officer. I also hold these same positions with TEP's parent company, UniSource Energy Corporation.

Q: Please provide us with a summary of your education and employment background.

A: I received an undergraduate degree in accounting with a minor in economics from Claremont Men's College. I received a Juris Doctor Degree from the University of San Diego School of Law and am a member of the California State Bar.

I have worked in the utility industry since my college days, with the exception of two years when I was in the military during the Vietnam War. I served in various positions at San Diego Gas & Electric Company and

Southern California Edison Company in accounting, economics, business planning and strategic planning.

Prior to joining TEP, I served as the Chief Executive Officer of Mission Energy, which was the largest independent power producer in the world at the time. So, as you can see, my experience and perspectives come from working with incumbent utilities as well as independent power producers.

Q: Mr. Pignatelli, what is the purpose of your initial testimony?

A: The purpose of my initial testimony is to personally convey to the Commission TEP's concerns, observations and recommendations regarding how to proceed with Electric Competition in Arizona from this point forward. My testimony will be offered in the context of the "Track A" issues outlined at pages 1-2 of the Procedural Order dated May 2, 2002.

I believe that Arizona has come to a crossroads regarding Electric Competition. By saying that Arizona has come to a cross-roads, I mean all of the participants in the State's electric utility industry—the customers, utility companies, Commission and even the merchant plant builders and energy service providers ("ESPs") who are looking to come into the local market. While some of the participants have expended significant amounts of time and money in pursuit of electric competition and have an interest in

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the outcome of this proceeding, I believe that incumbent utilities, such as TEP, who are anchored in the State and have the duty as provider of last resort for retail customers have the most at risk and will be most severely affected by these proceedings.

I commend the Commission for being willing to evaluate Electric Competition as it has evolved to this point in time. I want to encourage the Commission to continue to take the necessary steps to thoroughly analyze whether Electric Competition is really in the public interest. And, if it is, to put in place a framework that will provide real and quantifiable benefits to electric service customers. That is why my initial testimony not only discusses the Track A issues but also sets forth some recommendations for Commission action. I fully expect and hope that my recommendations will be the subject of discussion among the participants to this proceeding (including in rebuttal testimony) and will contribute to the public interest, namely, an established system for the provision of safe, reliable and fairly priced electric service.

If the Commission determines that Electric Competition is not in the public interest, or should not be implemented at this time, then I encourage the Commission to rescind or indefinitely stay the Electric Competition Rules and related orders.

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II. SUMMARY OF INITIAL TESTIMONY.

Q: Please summarize the testimony that TEP will be presenting.

A: In my initial testimony I provide the following:

1. A discussion of the present status of retail electric competition in Arizona and how that effects the Track A issues;
2. A summary of TEP's proposal for electric competition in the future including the Track A issues; and
3. A discussion of the need for the Commission to grant a variance to the A.A.C. R14-2-1606 and A.A.C. R14-2-1615 pending the re-evaluation of the Electric Competition Rules.

In addition to my testimony, TEP will present the initial testimony of Mr. Steven Glaser, Senior Vice-President and Chief Operating Officer of TEP, who will testify regarding the steps that TEP must undertake to implement the divestiture of its generation assets, the post-divestiture role of the utility distribution company and the function of the utility transmission company including how it might interact with the Federal Energy Regulatory Commission ("FERC"). Mr. Glaser will also address the status of Affiliate Interest Rules and Code of Conduct.

Mr. Michael DeConcini, Senior Vice-President of Strategic Planning and Investment of UniSource Energy Company, the parent company of TEP, will testify

regarding the role of the utility generation company, wholesale markets and related market power issues.

Q: Mr. Pignatelli, please describe the present status of retail electric competition in Arizona.

A: I suppose there is a short answer and a long answer to this question. The short answer is that there is very little retail electric competition and no residential retail electric competition in Arizona. The promise of "customer choice" has not translated into anything meaningful for the retail customer, especially the residential retail customer. Similarly, the touted benefit of reduced rates has not materialized, other than in the context of voluntary reductions agreed to by the incumbent utilities, like TEP, in settlement agreements.

In order to provide the long answer, I think I need to explain my views in the context of what has happened in Arizona in the name of "competition".

Q: Please explain your view of what has happened.

A: TEP has provided a chronology of Commission and legal proceedings related to Arizona electric competition in "Tucson Electric Power Company's First Response to Commission Questions" dated February 25,

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2002. I refer to the chronology mindful of its caveats. However, I really want to talk more about the practical reality of what has occurred.

In the mid 1990s, the concept of introducing competition into the otherwise regulated monopolistic retail electric industry was being discussed in several states. During that time, ideas such as "deregulation" and "competition" were being raised in Arizona. I believe that these were familiar terms to those of us who were involved at the time, but applying these economic theories to an existing industry steeped in government regulation proved to be extremely complicated. This is supported by the number of proceedings, both regulatory and legal, that were spawned by the attempts to put a framework for competition in place.

I believe the result of what has transpired in Arizona to date is more a shift in "regulation" than deregulation. And, although we refer to retail electric "competition", there appear to be few, if any, viable competitors. In other words, we may have retail competition in name, but not in actuality.

Q: What do you mean by a shift in regulation?

A: I mean that the Electric Competition Rules do not propose to completely remove the electric industry from the jurisdiction of the Commission; they merely seek to change the way that public service corporations are regulated. The Commission's jurisdiction has been further broadened to

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include entities such as ESPs that previously did not do business in Arizona.

Q: Can you provide an example of what you mean?

A: Yes, let me refer to several examples. The Commission still requires that public service corporations and ESPs receive certificates of convenience and necessity from the Commission in order to provide retail electric service. Potential power plant builders still must obtain certificates of environmental compatibility from the Commission. The Commission requires that the incumbent utilities still must act as providers of last resort for customers, even those who choose to receive electric service from ESPs. The rates that can be charged to customers, including those who leave a public service corporation and then return, are still subject to the Commission's rate regulation under the Electric Competition Rules. Additionally, if generation assets are divested, those assets will still be regulated, not by the Commission, but by the FERC.

Q: What do you mean that there is not actual retail electric competition in Arizona?

A: My observation is that, for all intents and purposes, there is no real retail electric competition in Arizona. It does not appear to me that ESPs are dedicating significant resources to provide a broad range of retail electric

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service in Arizona. Again, by way of example, I am only aware of two ESPs that are doing business in the TEP service territory—and both of those ESPs are owned by other incumbent utilities. I believe that at least one ESP, PG&E Energy Services, has actually requested, and been granted, de-certification in the State. Another ESP, Enron, years ago withdrew from residential retail electric competition in California and is not active in Arizona. To my knowledge no ESP is actively marketing its services to residential retail customers in TEP's service territory. I am aware of very few retail electric customers who have selected direct access service under the Electric Competition Rules. And, I am not aware of any concerted effort among a significant number of residential retail electric customers to support retail electric competition.

Q: Why do you believe that ESPs are not more active in retail electric competition in Arizona?

A: I am not sure I know all of the reasons. However, I do believe that it is almost impossible to build a viable ESP business plan based upon the demographics of the Arizona electric market alone. If you look at how each of the states in the western United States is dealing with the issue of electric competition, you will find a wide range of approaches. But it is safe to say that electric competition is the

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exception rather than the rule. I also think it is fair to say that ESPs must develop a business plan that will allow them to compete and be profitable. In light of the fact that Arizona is virtually alone in the Southwest in its ongoing development of electric competition, an ESP looking to serve in this area will be limited, to a large degree, to Arizona. I do not believe that, at this point in time, the Arizona retail electric market in general, and residential retail customers specifically, can sustain an aggressive ESP business plan.

Q: Why do you believe that there is not more of an interest in retail electric competition among electric service customers?

A: Simply because there is little choice. Without ESPs actively marketing customer choice, I believe that the majority of customers do not feel there is much of a choice—and they are probably correct. I realize that there is some aggressive marketing for Large Commercial and Industrial customers but traditionally, these customers have always negotiated the best deal that they could for electric service through special contracts. I believe they will continue to do so. I also believe that Residential and Small Commercial and Industrial customers are more interested in price stability and reliability than choice of suppliers.

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Q: Do you believe that competition among electric generators is viable?

A: I believe that with the proper procedures and safeguards in place, competition among electric generators for wholesale sales of electricity can be viable within a short period of time. I believe that in order for there to be competition among electric generators for retail sales of electricity there first must be an established and functioning wholesale market.

Q: What components do you believe need to be in place in order for the wholesale electric market to be compatible with electric competition?

A: Mr. DeConcini will address some of these issues in his testimony. I realize that many parties are looking into how to develop a manageable wholesale power market. Consequently, there are many different opinions on the subject. Complicating matters even more is what action, if any, FERC will take to further regulate the wholesale market. I believe that important components of a wholesale generation market are (a) a regional structure; (b) participants; (c) transmission access; and (d) an organization to operate the regional market. FERC has promoted the idea of Regional Transmission Organizations ("RTOs'") to standardize procedures and rules, ensure non-discriminatory access to transmission and to provide monitoring. TEP is one of the founding members of WestConnect, LLC, a proposed western region RTO.

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Q: Mr. Pignatelli, the Commission has asked the parties to provide testimony regarding its jurisdiction of generation assets that are transferred to a third party entity. What is TEP's position on that issue?

A: TEP has provided an explanation of its view of FERC jurisdiction over divested generation and transmission assets in "Tucson Electric Power Company's First Response to Commission Questions" dated February 25, 2002 at 53-57. To briefly summarize, TEP believes that this issue must be analyzed separately for the divestiture or transfer of generating assets and for the divestiture or transfer of transmission assets.

The divestiture of generation assets by TEP would not affect FERC's jurisdiction. Under the Federal Power Act, FERC has exclusive jurisdiction to determine the "justness" of wholesale rates for electric power. To the extent that the divested or transferred generating assets are used to make retail sales of power in Arizona, the Commission would have jurisdiction over the inclusion of those sales in rates in accordance with Arizona law. To the extent that wholesale sales of energy are made from the divested or transferred generating assets, FERC would have exclusive jurisdiction under the Federal Power Act to determine the just and reasonable rate at which such sales may occur.

The divestiture or transfer of transmission assets would result in FERC exercising jurisdiction over the rates, terms and conditions of any unbundled retail

transmission service that occurs as a result. Under section 201 of the Federal Power Act, FERC has jurisdiction over interstate transmission of electric energy. FERC has asserted jurisdiction over unbundled retail transmission service, that occurs when "a retail transaction is broken into two products [one being energy and one being transmission] that are sold separately (perhaps by two different suppliers: an electric supplier and a transmission supplier)" in FERC Order No. 888.

III. TEP'S PROPOSAL FOR ELECTRIC COMPETITION.

Q: What is TEP's proposal for Electric Competition in Arizona?

A: Again, let me begin my answer by putting TEP's position in proper context. I believe that one of the most critical components that will influence retail electric competition is generation price volatility in the wholesale market. Before a robust competitive retail market can exist in Arizona the art of balancing regional supply and demand without a regulatory mandate and delivery infrastructure issues must be addressed. For its part, the Commission can encourage the development of (a) additional generating resources and/or load management, which will be required to maintain a regional supply and demand balance; and (b) additional transmission infrastructure and new gas pipeline or railroad infrastructure that will be necessary to ensure adequate delivery capability to customers and fuel supply to generators.

Incumbent utilities, such as TEP, should be allowed the flexibility to develop a portfolio approach to serving the needs of their Standard Offer customers, which

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will help mitigate the impact of any short-term price spikes or dips and smooth out the average price that the customer pays. Also, when acting as a provider of last resort to serve Standard Offer customers, incumbent utilities should be allowed to implement purchased power and fuel adjustment clauses in order to mitigate unreasonable risk and volatility to their shareholders.

Q: Do you believe there should be changes in the present Electric Competition Rules?

A: I do think that some changes are in order. I believe that in a competitive regime, it is appropriate for incumbent utilities to be permitted to divest their generation and transmission assets into one or more affiliated companies. The result would be separate generation, transmission and distribution affiliates. The generation affiliate would be subject to FERC jurisdiction for wholesale sales. The transmission affiliate would be associated with an established RTO (and subject to its policies and procedures). The distribution affiliate would ultimately provide electricity and related services to the customer and be subject to the jurisdiction of the Commission.

I also believe that in order to maintain reliability and economic stability, competitive bidding should be phased in proportionate to the growth and stability of the wholesale competitive market.

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Q: Do you believe that there should be any limitations on customers who are subject to Electric Competition?

A: Yes, I do. Because there is no real competition for Residential customers, and customers (Commercial and Industrial) with loads under 3 MW, I would propose that these two classifications of customers be excluded from electric competition. As time passes and electric competition matures, some or all of these customers may eventually be included within the scope of competition. These issues are addressed in more detail in the testimony of Messrs. Glaser and DeConcini.

Q: Mr. Pignatelli, do you believe that TEP's Settlement Agreement with parties as approved by the Commission should be amended?

A: If the Commission retains electric competition materially and substantially in the form that it exists today, then I do not think that the Settlement Agreement needs to be substantively amended. I do, however, urge the Commission to (a) accept the Motion for Clarification of Settlement Agreement dated March 14, 2002 (Exhibit 1 hereto); and (b) grant the TEP Request for Variance (Exhibit 2 hereto). Basically, I think that if the terms of competition remain the same, then TEP can operate under the terms of the Settlement Agreement. However, if the Electric Competition Rules are materially changed or repealed, then I want to make it clear that TEP will reserve its right to negotiate new terms in connection with the new form of competition.

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IV. THE NEED FOR THE COMMISSION TO GRANT A VARIANCE TO A.A.C. R14-2-1606 and A.A.C. R14-2-1615 PENDING THE RE-EVALUATION OF THE ELECTRIC COMPETITION RULES.

Q: Mr. Pignatelli, why did TEP request a variance to A.A.C. R14-2-1606 and A.A.C. R14-2-1615?

A: TEP requested a variance after the Commission made it clear that it was going to re-evaluate the Electric Competition Rules. On December 5, 2001, both Chairman Mundell and Commissioner Spitzer filed letters indicating that they wanted to revisit the Electric Competition Rules. These were followed up by additional correspondence from all of the Commissioners regarding the re-evaluation. TEP was concerned that at the same time the Commission was going to be re-evaluating the Electric Competition Rules, those very same rules imposed upon TEP the obligation to divest its generating assets and to begin to competitively bid its power needs by December 31, 2002. These are monumental tasks and significant events with serious consequences for the future of TEP—and the Commission's jurisdiction over TEP's assests. TEP did not feel it was in the public interest to proceed with the divestiture and competitive bid process amid the uncertainty of what the Commission would do relative to the Electric Competition Rules, so we requested that the status quo remain until the re-evaluation was completed. This seemed to be the logical course to follow then and it still seems to be so now.

Q: Do you believe that a variance still is needed?

A: Yes, I do.

Q: Why?

A: Because we are now in late May and we still do not know what the final outcome will be of the Commission's re-evaluation of the Electric Competition Rules.

Q: Is the variance needed if the Commission completes its review of the Track A and Track B issues by October 21, 2002?

A: Yes, it is. I believe that it is extremely optimistic to think that the Commission can complete its review of the Track A and Track B issues by October 21, 2002. I am not sure it is wise to put such a fast track on the resolution of these important issues. There are many differing views among the parties regarding the Track A and Track B issues that need to be carefully analyzed and then decided. After the matters are resolved generically, TEP believes that the Commission must determine how issues such as competitive solicitation will be specifically applied to the unique characteristics of TEP, its system and its customers. On May 13, 2002, TEP submitted its Track B Proposals which recommended a procedure that would resolve the Track A and Track B issues by February 20, 2003. TEP's variance would be needed to postpone the compliance deadlines until the Track A and Track B issues were decided by the Commission.

Even if the October 21, 2002 deadline is met, that would leave TEP with a little over two (2) months to interpret the final Commission rulings, and implement the

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divestiture of its assets and complete the competitive solicitation process. I think these may be impossible undertakings within such a short time frame.

Although the parties may disagree as to whether competition is in the public interest, I think that everyone will agree that hastily and badly created competition can be worse than no competition. Consequently, I am renewing our request that the Commission provide us with some certainty and grant the variance until the re-evaluation of the Electric Competition Rules has been completed. I should note that TEP has already filed testimony to support the variance. If any party wishes to file additional testimony regarding TEP's Request for Variance, it can do so in its rebuttal testimony due in this docket. The Commission can then rule on the TEP's Request for Variance within a reasonable time frame.

V. TEP RECOMMENDATIONS REGARDING TRACK A ISSUES.

Q: Mr. Pignatelli, what are your recommendations for Commission action regarding the Track A issues?

A: Perhaps the best way for me to present my recommendations is to simply list them:

1. The Commission should issue findings of fact that detail the purported benefits of electric competition both on a retail and wholesale basis.

I believe that the Commission's re-evaluation of Electric Competition should include a review of the basic premise that competition is in the public interest. When I think of all of the time and money spent in implementing competition in

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this State compared to where we are, and when I look at the experience of other states such as California, Nevada and New Mexico, I have to question whether competition is, in fact, the most appropriate regime for the electric industry. And if it is, when is the best time to implement it? I believe that by requiring proponents of electric competition to come forward with credible evidence of the anticipated benefits of electric competition, the Commission will be in a position to affirm or reject what seems to be the presumption that Electric Competition is the best manner for providing electric service in Arizona. Findings of fact will also provide all participants (and future Commissions) with a tool for measuring the success of competition in the future.

2. Grant the TEP Request for Variance.

It is important for the Commission to preserve the status quo of the utilities and of its jurisdiction over them during the re-evaluation period.

3. Adopt TEP's Track B procedural proposal.

In connection with the grant of TEP's Request for Variance, the Commission should carefully proceed, at a measured pace, to analyze all aspects of Electric Competition and implement a comprehensive set of rules, policies and procedures to bring about real competition.

4. Amend the Electric Competition Rules in Accordance with the proposals in TEP's Track A and Track B testimony.

In our Track B Proposals filing, we indicated that Track A issues and Track B issues are related and should be considered together. In the testimony of Mr.

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Glaser, Mr. DeConcini, myself and other TEP witnesses that will be filed, we make proposals and recommendations for the amendment of the Electric Competition Rules. We would urge the Commission to adopt the recommendations and amend the Electric Competition Rules accordingly.

Q: Does this conclude your initial testimony?

A: Yes, it does.

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EXHIBIT "1"

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IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY AND FOR RELATED APPROVALS, AUTHORIZATIONS AND WAIVERS	Docket No. E-01933A-98-0471
IN THE MATTER OF THE FILING OF TUCSON ELECTRIC POWER COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1602 *et seq.*	Docket No. E-01933A-97-0772
TUCSON ELECTRIC POWER COMPANY APPLICATION FOR APPROVAL OF ITS PROPOSED DIRECT ACCESS SERVICE FEES AND ITS PROPOSED AMENDMENTS TO ITS RULES AND REGULATIONS.	Docket No. E-01933A-99-0729
IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	Docket No. RE-00000C-94-0165 **MOTION FOR CLARIFICATION OF SETTLEMENT AGREEMENT**

Tucson Electric Power Company ("TEP"), Arizonans for Electric Choice and Competition ("AECC"), Arizona Community Action Association ("ACAA") and the Arizona Residential Utility Consumer Office ("RUCO") (sometimes collectively referred to as the "Parties"), hereby move the Commission for an order approving a clarification of the Settlement Agreement between the Parties approved in Decision No. 62103 (the

"Settlement Agreement"), as set forth below. In support hereof, the Parties state as follows:

On June 9, 1999, the Parties entered into the Settlement Agreement, which provided for resolution of issues necessary for implementing the Commission's Electric Competition Rules. The Settlement Agreement, with modifications, was subsequently approved by the Commission in Decision No 62103.The Settlement Agreement provided TEP the opportunity to recover its stranded costs through the implementation of a Competition Transition Charge ("CTC"). Since approval of the Settlement Agreement, the Parties have concluded that some clarification of the provisions relating to the calculation of the Market Generation Credit ("MGC") is required to insure complete and full implementation of the settlement as intended by the Parties. In particular, Paragraph 2.1(d) of the Settlement Agreement requires TEP, in calculating the MGC, to use off-peak to on-peak price ratios from the California Power Exchange and the Palo Verde NYMEX futures price. The California Power Exchange and the Palo Verde NYMEX futures price no longer exist, necessitating a clarification to this provision.

The Parties agree, in accordance with Paragraph 13.2 of the Settlement Agreement, that the clarification of the MGC calculation presented herein is consistent with the Parties' intent in entering into the Settlement Agreement and does not change the underlying logic of the MGC calculation. The parties have entered into a Memorandum of Understanding that sets forth the clarification of the Settlement Agreement. A "Red-Lined Version" of the Memorandum of Understanding is attached hereto as Exhibit 1, and by this

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reference, incorporated herein. An executed copy of the revised Memorandum of Understanding is attached hereto as Exhibit 2, and by this reference incorporated herein.

The clarification is as follows:

(i) Paragraph 2.1(d) of the Settlement Agreement is clarified by the following:

a. The monthly MGC amount shall be calculated in advance and shall be comprised of 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 Palo Verde futures 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.

b. The off-peak MGC component shall be determined in the same manner as the on-peak component, except that the Palo Verde futures price will be adjusted by the ratio of the simple average of off-peak to on-peak hourly prices from the Dow Jones Palo Verde Index of the same month from the preceding year.

c. 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.

(ii) Paragraph 2.1(e) of the Settlement Agreement is clarified by the following:

The parties acknowledge that the purpose of the Adder is to estimate the cost of supplying power to a specific customer or customer group and stratum relative to the value of the futures price used in the calculation of the market price for a one hundred percent (100%) load factor. The Adder will be adjusted for each customer class and stratum, shall average 4.2 mills and shall be subject to the same line loss adjustment outlined in subsection (d) herein. However, the initial Adder for any customer shall not be less than 3.0 mills.

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(iii) Paragraph 2.1(j) of the Settlement Agreement is clarified by the following:

> During a month which must-run generation is provided to meet retail load, the Market Price component used in calculating the on-peak MGC shall be a weighted average of the Platts Long-Term Forward Assessment for Palo Verde futures price and the must-run variable cost charges that are levied on scheduling coordinators serving retail customers in the TEP load zone during that month, consistent with AISA or successor transmission organization protocols.

Wherefore, for all of the foregoing reasons, the Parties request that the Commission issue its Order approving the clarification as set forth herein.

RESPECTFULLY SUBMITTED this 14th day of March, 2002.

ROSHKA HEYMAN & DEWULF

By _____

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1

Red-Lined Version

MEMORANDUM OF UNDERSTANDING

This Memorandum of Understanding is entered into this ___ day of November, 2001, between TUCSON ELECTRIC POWER COMPANY ("TEP"), ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION ("AECC") and RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") (also sometimes collectively referred to as the "Parties").

A. On June 9, 1999, the Parties entered into a Settlement Agreement, which provided for resolution of issues necessary for implementing the Arizona Corporation Commission's ("Commission") Electric Competition Rules.

B. The Settlement Agreement, with modifications, was subsequently approved by the Commission.

C. The Settlement Agreement authorized TEP the opportunity to recover its stranded costs through the implementation of a Competition Transition Charge ("CTC").

D. Since the commencement of the implementation of the Settlement Agreement, the Parties have concluded that some clarification of the provisions relating to the calculation of the Market Generation Credit ("MGC") is required to insure complete and full implementation of the settlement as intended by the Parties.

E. In particular, Paragraph 2.1(d) of the Settlement Agreement requires TEP, in calculating the MGC, to use off-peak to on-peak price ratios from the California Power Exchange and the Palo Verde NYMEX futures price. The California Power Exchange and the Palo Verde NYMEX futures price no longer exist~~s~~, necessitating a clarification to this provision.

In accordance with Paragraph 13.2 of the Settlement Agreement, the following clarifications set forth the understanding of the Parties and the Parties agree are consistent with the Settlement Agreement and do not change the underlying logic of the MGC calculation.

1. *Paragraph 2.1(d) of the Settlement Agreement is clarified by the following:*

(a) The monthly MGC amount shall be calculated in advance and shall be comprised of 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 ~~Palo Verde NYMEX~~Platts Long-Term Forward Assessment for Palo Verde futures 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 ~~Palo Verde NYMEX~~Platts Long-Term Forward Assessment for Palo Verde settlement prices.

(b) The off-peak MGC component shall be determined in the same manner as the on-peak component, except that the Palo Verde futures price will be adjusted by the ratio of the simple average of off-peak to on-peak hourly prices from the Dow Jones Palo Verde Index~~California Power Exchange (AZ3)~~ of the same month from the preceding year.~~, through January 2002. Thereafter, the off-peak MGC component will be adjusted by the ratio of the simple average of off-peak to on-peak hourly prices from the Dow Jones Palo Verde Index of the same month from the preceding year.~~

(c) 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.

2. Paragraph 2.1(e) of the Settlement Agreement is clarified by the following:

The parties acknowledge that the purpose of the Adder is to estimate the cost of supplying power to a specific customer or customer group and stratum relative to the value of the futures price used in the calculation of the market price for a one hundred percent (100%) load factor. The Adder will be adjusted for each customer class and stratum, shall average 4.2 mills and shall be subject to the same line loss adjustment outlined in subsection (d) herein. However, the initial Adder for any customer shall not be less than 3.0 mills.

3. Paragraph 2.1(j) of the Settlement Agreement is clarified by the following:

During a month which must-run generation is provided to meet retail load, the Market Price component used in calculating the on-peak MGC shall be a weighted average of the Platts Long-Term Forward Assessment for Palo Verde futures price and the must-run variable cost charges that are levied on scheduling coordinators serving retail customers in the TEP load zone during that month, consistent with AISA or successor transmission organization protocols.

It is not the intent of the Parties by entering into this Memorandum of Understanding to amend the Settlement Agreement, but only to make more clear certain provisions as set forth above.

EXECUTED ON _____, 2001.

TUCSON ELECTRIC POWER COMPANY

By _____

Its _____

ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION

By _____

Its _____

RESIDENTIAL UTILITY CONSUMER OFFICE

By _____

Its _____

ARIZONA COMMUNITY ACTION ASSOCIATION

By _____

Its _____

Red-Lined Version

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A. On June 9, 1999, the Parties entered into a Settlement Agreement, which provided for resolution of issues necessary for implementing the Arizona Corporation Commission's ("Commission") Electric Competition Rules.

B. The Settlement Agreement, with modifications, was subsequently approved by the Commission.

C. The Settlement Agreement authorized TEP the opportunity to recover its stranded costs through the implementation of a Competition Transition Charge ("CTC").

D. Since the commencement of the implementation of the Settlement Agreement, the Parties have concluded that some clarification of the provisions relating to the calculation of the Market Generation Credit ("MGC") is required to insure complete and full implementation of the settlement as intended by the Parties.

E. In particular, Paragraph 2.1(d) of the Settlement Agreement requires TEP, in calculating the MGC, to use off-peak to on-peak price ratios from the California Power Exchange and the Palo Verde NYMEX futures price. The California Power Exchange and the Palo Verde NYMEX futures price no longer exists, necessitating a clarification to this provision.

In accordance with Paragraph 13.2 of the Settlement Agreement, the following clarifications set forth the understanding of the Parties and the Parties agree are consistent with the Settlement Agreement and do not change the underlying logic of the MGC calculation.

1. Paragraph 2.1(d) of the Settlement Agreement is clarified by the following:

(a) The monthly MGC amount shall be calculated in advance and shall be comprised of 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 ~~Palo Verde NYMEX~~Platts Long-Term Forward Assessment for Palo Verde futures price, except when adjusted for the variable cost of TEP's must-run generation.

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The parties acknowledge that the purpose of the Adder is to estimate the cost of supplying power to a specific customer or customer group and stratum relative to the value of the futures price used in the calculation of the market price for a one hundred percent (100%) load factor. The Adder will be adjusted for each customer class and stratum, shall average 4.2 mills and shall be subject to the same line loss adjustment outlined in subsection (d) herein. However, the initial Adder for any customer shall not be less than 3.0 mills.

3. Paragraph 2.1(j) of the Settlement Agreement is clarified by the following:

During a month which must-run generation is provided to meet retail load, the Market Price component used in calculating the on-peak MGC shall be a weighted average of the Platts Long-Term Forward Assessment for Palo Verde futures price and the must-run variable cost charges that are levied on scheduling coordinators serving retail customers in the TEP load zone during that month, consistent with AISA or successor transmission organization protocols.

It is not the intent of the Parties by entering into this Memorandum of Understanding to amend the Settlement Agreement, but only to make more clear certain provisions as set forth above.

EXECUTED ON _____, 2001.

TUCSON ELECTRIC POWER COMPANY

By _____

Its _____

ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION

By _____

Its _____

RESIDENTIAL UTILITY CONSUMER OFFICE

By _____

Its _____

ARIZONA COMMUNITY ACTION ASSOCIATION

By _____

Its _____

2

MEMORANDUM OF UNDERSTANDING

This Memorandum of Understanding is entered into this ___ day of _____, 2002, between TUCSON ELECTRIC POWER COMPANY ("TEP"), ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION ("AECC") Arizona Community Action Association ("ACAA") and RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") (also sometimes collectively referred to as the "Parties").

A. On June 9, 1999, the Parties entered into a Settlement Agreement, which provided for resolution of issues necessary for implementing A.A.C.R. 14-2-1601 et. seq. ("Electric Competition Rules").

B. The Settlement Agreement, with modifications, was subsequently approved by the Arizona Corporation Commission ("Commission") in Decision No. 62103.

C. The Settlement Agreement provided TEP the opportunity to recover its stranded costs through the implementation of a Competition Transition Charge ("CTC").

D. Since the commencement of the implementation of the Settlement Agreement, the Parties have concluded that some clarification of the provisions relating to the calculation of the Market Generation Credit ("MGC") is required to insure complete and full implementation of the Settlement Agreement as intended by the Parties.

E. In particular, Paragraph 2.1(d) of the Settlement Agreement requires TEP, in calculating the MGC, to use off-peak to on-peak price ratios from the California Power Exchange and the Palo Verde NYMEX futures price. The California Power Exchange and the Palo Verde NYMEX futures price no longer exist, necessitating a clarification to this provision.

The Parties agree in accordance with Paragraph 13.2 of the Settlement Agreement, that the following clarification is consistent with the Settlement Agreement and does not change the underlying logic of the MGC calculation:

1. Paragraph 2.1(d) of the Settlement Agreement is clarified by the following:

(a) The monthly MGC amount shall be calculated in advance and shall be comprised of 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 Palo Verde futures 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.

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The parties acknowledge that the purpose of the Adder is to estimate the cost of supplying power to a specific customer or customer group and stratum relative to the value of the futures price used in the calculation of the market price for a one hundred percent (100%) load factor. The Adder will be adjusted for each customer class and stratum, shall average 4.2 mills and shall be subject to the same line loss adjustment outlined in subsection (d) herein. However, the initial Adder for any customer shall not be less than 3.0 mills.

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During a month which must-run generation is provided to meet retail load, the Market Price component used in calculating the on-peak MGC shall be a weighted average of the Platts Long-Term Forward Assessment for Palo Verde futures price and the must-run variable cost charges that are levied on scheduling coordinators serving retail customers in the TEP load zone during that month, consistent with AISA or successor transmission organization protocols.

It is not the intent of the Parties by entering into this Memorandum of Understanding to amend the Settlement Agreement, but only to make more clear certain provisions as contemplated by Paragraph 13.2 of the Settlement Agreement.

EXECUTED ON march 14, 2002.

TUCSON ELECTRIC POWER COMPANY

By _____

Its Attorney

ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION

By _____

Its President

RESIDENTIAL UTILITY CONSUMER OFFICE

By _____

Its Director

ARIZONA COMMUNITY ACTION ASSOCIATION

By _____

Its Energy Program Manager

EXHIBIT "2"

BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONER

IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION RULES COMPLIANCE DATES.	Docket No. E-01933A-02-0069 **TUCSON ELECTRIC POWER COMPANY'S REQUEST FOR A VARIANCE**

Tucson Electric Power Company ("TEP"), through undersigned counsel, and pursuant to A.A.C. R14-2-1614.C, respectfully requests that the Arizona Corporation Commission ("Commission") grant TEP a variance for the compliance dates set forth in A.A.C. R14-2-1606.B ("Rule 1606.B") and A.A.C. R14-2-1615.A ("Rule 1615.A"). Specifically, TEP is requesting that the Commission grant:

1. An extension of the compliance date in Rule 1606.B, which requires that power purchased by TEP for Standard Offer Service "shall be acquired from the competitive market through prudent, arm's length transactions, and with at least 50% through a competitive bid process"; and

2. An extension of the compliance date in Rule 1615.A, which requires that all competitive generation assets and competitive services be separated from TEP.

TEP requests that the compliance dates be extended to either: (a) December 31, 2003; or (b) a date six months after the Commission has issued a final order in "In the Matter of the Generic Proceedings Concerning Electric Restructuring Issues," A.C.C.

Docket No. E-00000A-02-0051 (the "Generic Restructuring Docket"),[1] whichever is the later date.

Finally, as is discussed more fully herein, although TEP does not believe that this Request for a Variance will require a modification of the TEP Settlement Agreement, TEP requests that, to the extent required, the Commission approve any modification to the Settlement Agreement approved in Decision No. 62103 (the "TEP Settlement Agreement") deemed necessary in connection with this Request for a Variance. In support hereof, TEP states:

1. BACKGROUND.

The current version of Rule 1606.B states:

> After January 1, 2001, power purchased by an investor-owned Utility Distribution Company for Standard Offer Service shall be acquired from the competitive market through prudent, arms length transactions, and with at least 50% through a competitive bid process (the "50% bid requirement").

Thus, pursuant to Rule 1606.B, TEP will be obligated to purchase at least 50% of the power for its Standard Offer Service through a competitive bid process.

Rule 1615.A states:

> All competitive generation assets and competitive services shall be separated from an Affected Utility prior to January 1, 2001. Such separation shall either be to an unaffiliated party or to a separate corporate affiliate or affiliates. If an Affected Utility chooses to transfer its competitive generation assets or competitive services to a competitive electric affiliate, such transfer shall be at a value determined by the Commission to be fair and reasonable (the "generation separation requirement").

---

[1] TEP's request contemplates that all of the issues raised in A.C.C. Docket No. E-01345A-01-0822 (the "APS Variance Case"), A.C.C. Docket No. E-00000A-01-0630 (the "AISA Case") and the Generic Restructuring Docket will be consolidated and resolved in the Generic Restructuring Docket. In the event that consolidation of those cases does not occur, then TEP requests that the six-month period begin only when there are final orders resolving all of the issues raised in the APS Variance Case, AISA Case, this case and the Generic Restructuring Docket.

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Pursuant to this rule, TEP will be obligated to separate its "competitive generation assets and competitive services" by transferring them to either an unaffiliated party or to a separate corporate affiliate or affiliates. Although these rules originally set a compliance date of January 1, 2001, the TEP Settlement Agreement established a new 50% bid requirement deadline and generation separation requirement deadline for TEP of December 31, 2002. [Decision No. 62103 at 14 and Attachment 1 at para. 3]

2. THE REQUESTED VARIANCE IS IN THE PUBLIC INTEREST.

TEP's variance request is reasonable, limited to a defined period of time and, consequently, in the public interest. TEP's requested variance will maintain the status quo while the Commission re-visits the Electric Competition Rules and related issues rather than force TEP to undertake costly and permanent steps that might negatively impact TEP, its customers and the Commission's jurisdiction over TEP's generation assets. Indeed, the 50% bid requirement and the generation separation requirement will cause major, and in some instances, permanent modifications to TEP's operations. To implement those requirements will require a substantial commitment of TEP time and resources. To take these steps at a time when the Commission and interested parties will be re-visiting the Electric Competition Rules, which might result in a modification of the 50% bid requirement and the generation separation requirement, does not seem to be prudent.

TEP's concern about the long-term status of the Electric Competition Rules is based upon recent events that have occurred in connection with the Generic Restructuring Docket such as: (a) the comments of the Commissioners regarding the need to re-visit the Electric Competition Rules at the December 5, 2001 procedural conference in the APS Variance Case; (b) the letters expressing the same sentiment filed by Chairman Mundell and Commissioner Spitzer on December 5, 2001; (c) the comments of Commission Staff filed in response to the APS Variance Case application; (d) the comments filed by the parties and intervenors in response to the December 11, 2001 Procedural Order; (e) Chairman Mundell's letter, dated January 14, 2002, which directed the Chief Administrative Law

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Judge to open a generic docket regarding the Electric Competition Rules and to consolidate it with the APS Variance Case and the AISA case and which invited interested parties to respond to questions regarding Electric Competition; (f) the Commission's Procedural Order, dated January 22, 2002, which opened the Generic Restructuring Docket; and (g) Commissioner Sptizer's letter dated January 22, 2002 which invited parties to answer additional questions regarding Electric Competition.

Moreover, given the recent history – and current state – of the western power markets, TEP believes that neither an immediate transition to the 50% competitive bid requirement or the generation separation requirement is prudent at this time.

For example, TEP believes that if it is required to meet the 50% bid requirement, both TEP and its customers will be subject to the following negative situations. First, the potential availability of reasonable competitive bids is simply unknown. Today, the entire western wholesale power market is in a state of flux. That evolving market – including recent and ongoing FERC activity, numerous proposed merchant plants and uncertainty about transmission issues – makes it difficult to evaluate the reasonableness of competitive bids in terms of duration of a contract and other contract terms.

Second, being obligated to a 50% bid requirement puts TEP at a distinct disadvantage in obtaining acceptable bids. The experience of utilities in California demonstrated that regulatory obligations placed on retail energy providers (such as TEP), can create economic hardships for those providers in an immature competitive market. The 50% bid requirement potentially could increase the cost of wholesale power to be used for Standard Offer Service.

Third, the California experience confirms the desirability of financially stable utility distribution companies that can provide reliable service. The potential restrictions of the 50% bid requirement in an uncertain generation market may subject TEP to unwarranted financial difficulties.

Fourth, the financial instability of some power marketers raises significant concerns.

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TEP is concerned that if it is dependent upon obtaining a significant amount of its power from these sources, it may not be able to meet its duty to provide reliable power to its customers.

Extending the TEP compliance dates will merely allow a timely reconsideration of these issues and the Electric Competition Rules, as a whole, without requiring TEP to prematurely commit to significant changes that may not be required in the future.

TEP also believes that the variance is appropriate in light of the TEP Rate Case Settlement Agreement approved in Decision No. 62103. Under that Settlement, TEP customers have enjoyed rate reductions since 1999. [*See* Decision No. 62103 at Attachment 1 ("Settlement Agreement"), para. 5.1] TEP also agreed to freeze rates at those reduced levels through 2008. [Settlement Agreement, paras. 5.1, 13.4] However, the TEP Settlement Agreement also provides that TEP may seek to change those rates prior to the end of 2008 in the event of (i) conditions or circumstances that constitute an emergency or (ii) material changes in TEP's cost of service for Commission-regulated services resulting from "federal, state or local laws, regulatory requirements, judicial decisions, actions or orders. [Settlement Agreement, para. 13.4] TEP is concerned that premature compliance with rules that may be changed could cause material changes in TEP's cost of Standard Offer Service and may create emergency circumstances for TEP. The requested compliance extension will eliminate that concern while the Commission reviews the Electric Competition Rules.

3. TEP SETTLEMENT AGREEMENT.

Although TEP does not believe that the variance will materially modify the TEP Settlement Agreement, it recognizes that other parties may argue to the contrary. To avoid any such controversy, TEP further requests that if the Commission determines that the variance does modify the TEP Settlement Agreement, then an order be issued approving any such modification. Further, TEP has, in good faith, provided ample prior notice of this filing to the parties to the TEP Settlement Agreement. TEP has conferred with the parties

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to the TEP Settlement Agreement, informed them of its intent to file a request for a variance and provided them with a copy of this pleading several days prior to filing it with the Commission.

4. CONCLUSION.

WHEREFORE, for all of the foregoing reasons, TEP requests that the Commission issue an order granting TEP's Request for a Variance to the compliance dates for A.A.C. R14-2-1606.B and A.A.C. R14-2-1615.A as set forth herein.

Respectfully submitted this 28th day of January, 2002.

ROSHKA HEYMAN & DEWULF, PLC

By _____

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Attorneys for Tucson Electric Power Company

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The Honorable Jim Irvin, Commissioner
The Honorable Marc Spitzer, Commissioner

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Chief Administrative Law Judge
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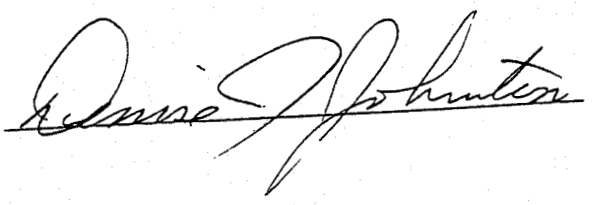

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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING ELECTRIC RESTRUCTURING ISSUES.	Docket No. E-00000A-02-0051
IN THE MATTER OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. 4-14-2-1606	Docket No. E-01345A-01-0822
IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR	Docket No. E-00000A-01-0630
IN THE MATTER OF TUCSON ELECTRIC COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC POWER COMPETITION RULES COMPLIANCE DATES	Docket No. E-01933A-98-0471
ISSUES IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION RULES COMPLIANCE DATES	Docket No. E01933A-02-0069

INITIAL TESTIMONY OF STEVEN J. GLASER

TUCSON ELECTRIC POWER COMPANY

TRACK A ISSUES

May 29, 2002

INITIAL TESTIMONY OF STEVEN J. GLASER
TRACK A ISSUES
May 29, 2002

I. INTRODUCTION.

Q. Please state your name and business address.

A. My name is Steven J. Glaser. My business address is One South Church Avenue, Tucson, Arizona 85701.

Q. What is your position with Tucson Electric Power Company ("TEP")?

A: I am Senior Vice President and Chief Operating Officer of the Utility Distribution Company.

Q: What are your duties and responsibilities at TEP?

A: My duties and responsibilities include overseeing all aspects of TEP's transmission and distribution systems. I am also responsible for overseeing TEP's filings and proceedings related to the Arizona Corporation Commission ("Commission").

Q: What is the purpose of your initial testimony?

A: The primary purpose of my initial testimony is to:

1. Discuss the steps that TEP must take to implement the divestiture of its generation assets;

2. Explain the post-divestiture role of the utility distribution company ("UDC");

3. Explain the post-divestiture role of the utility transmission company; and

4. Discuss the impact of TEP's recommendations for electric competition on the TEP Code of Conduct and Affiliate Interest Rules (A.A.C. R14-2-801, et. seq.)

II. IMPLEMENTATION OF DIVESTITURE OF GENERATION ASSETS.

Q: Please explain TEP's obligation to divest its generation assets.

A: Pursuant to A.A.C. R14-2-1615.A (as modified by the TEP Settlement Agreement), by December 31, 2002, TEP must transfer ownership in its generation assets to a third party entity (the "divestiture requirement").

Q: Please describe the steps that TEP must take to comply with the divestiture requirement.

A: The steps that TEP must take to comply with the divestiture requirement include forming and staffing a generation entity, and executing contract assignments from TEP to the new entity. These steps will require significant involvement by outside legal and accounting personnel.

The formation of a new generation entity requires (1) establishing the entity, (2) obtaining federal and state tax identification numbers, (3) preparing corporate

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record books, (4) establishing employee benefit plans, (5) hiring and/or transferring employees, (6) consulting with union officials regarding employee transfers; (7) establishing accounting and other information systems; and (8) establishing operating policies and procedures.

In addition, TEP has identified over 200 agreements and permits that may need to be assigned by TEP to the new generation entity. Certain of these assignments require third party consents, which may require negotiation as to the terms and conditions of each consent.

Finally, in connection with the divestiture requirement, TEP will need to obtain legal, tax and financial accounting services to review the transaction, corporate structure, and intercompany relationships between TEP and the generation entity.

Q: Mr. Glaser, what are TEP's plans regarding the transfer of its generation assets?

A: TEP is preparing to separate its operations into operating areas to be conducted by affiliates. One (or more) of the affiliates would be a generating company and would own and operate the generation assets. Another affiliate would be the UDC, which would obtain electric power from generating companies (including generating affiliates) and provide electric service to retail customers. Still another affiliate would own and operate TEP's transmission lines and related property. This affiliate would likely interact with regional transmission organizations and the Federal

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Energy Regulatory Commission ("FERC"). As discussed herein, depending on the outcome of these proceedings and matters before FERC, a separate TEP affiliate could own TEP's transmission assets.

Q: When does TEP expect to complete the transfer of its generation assets and the formation of its new affiliates?

A: We are supposed to transfer the generation assets by December 31, 2002. However, TEP has requested a variance from this deadline until the Commission has completed its review of the Electric Competition Rules. I want to encourage the Commission to grant TEP's Request for Variance. As the December 31, 2002 deadline draws closer the need for the variance becomes more urgent.

Q: How will the transfer of generation assets from TEP to another entity impact the Commission's jurisdiction over TEP's assets?

A: The transfer of TEP's generation assets to a separate entity will result in the Commission ceding regulation of assets engaged in wholesale transactions to FERC. Mr. Pignatelli addresses TEP's analysis of this issue in more detail in his initial testimony. The impact of the divestiture of TEP's generation assets on the Commission's jurisdiction is one of the key reasons TEP has requested the variance.

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III. THE POST-DIVESTITURE ROLE OF THE UDC.

Q. What will be the UDC's role after the divestiture of TEP's generation assets?

A. The UDC will obtain electric power from generators and marketers and provide electric services to retail customers. As Mr. Pignatelli explained in his initial testimony, TEP is proposing that retail customers with load requirements less than 3 MW be exempted from retail electric competition. To the extent that there are competitors for Arizona retail electric customers the UDC will compete for those customers. TEP envisions that the UDC will also be the "provider of last resort" for electric users that are within its currently designated service territory. I should point out that TEP believes that there should be rules in place that govern the terms and conditions for "provider of last resort" service for customers that choose direct access electric service.

Q: How will the UDC procure electric power pursuant to the Electric Competition Rules' competitive solicitation requirement?

A: A.A.C. R14-21606 (B) and our Settlement Agreement require that by January 1, 2003, electric power purchased by TEP for Standard Offer Service "shall be acquired from the competitive market through prudent, arm's length transactions, and with at least 50% through a competitive bid process." So, the UDC will need to look at procuring electric power through traditional means (such as contracts) as well as through a competitive bid process that, as of yet, has not been defined.

Again, we have asked for a variance to this requirement until the Commission completes its re-evaluation of the Electric Competition Rules and can provide the necessary detail to inform the UDC what the competitive solicitation process is. However, until the TEP Request for Variance is granted or the Commission indicates that the Electric Competition Rules will be changed, we have been working under the assumption that the requirements and deadlines stated in the current version of the rules are still applicable. We are mindful of the Commission's Affiliate Interest Rules as well as our Code of Conduct and will procure electric power within the permissible parameters set in those documents.

We are also very interested in the outcome of the Track B portion of this docket. The policies and procedures that are established by the Commission as a result of that proceeding will have an obvious impact on how the UDC procures electric power. Of particular interest to me is whether the "50% requirement" will remain as it is or if it will be phased-in over time. Also, by the time that the "50% requirement" is in place TEP will have to be proficient in whatever competitive bid process the Commission imposes. It is important that there be ample time between the Commission's announcement of the approved competitive solicitation process and the implementation date for the process to be put in place and for the participants, such as the UDC to be familiar with its operation.

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Q: How will the UDC procure electric power for the remainder of its Standard Offer load?

A: As part of our Settlement Agreement, TEP has agreed on a rate moratorium (which actually incorporated some rate decreases) through 2008. During the rate moratorium period, the UDC will procure electric power, other than for the 50% requirement, through a Purchase Power Agreement ("PPA") with a generation company, which could include a TEP generation affiliate.

Upon expiration of the rate moratorium, the UDC will continue to procure electric power for all Standard Offer load through a combination of the competitive solicitation process and a PPA.

I believe that it may be appropriate, and that the Commission should consider in its re-evaluation of the Electric Competition Rules, for the UDC to have a Purchase Power and Fuel Adjustment ("PPFA") mechanism in place subsequent to the divestiture of the generation assets.

IV. THE POST-DIVESTITURE ROLE OF THE UTILITY TRANSMISSION COMPANY.

Q: What will be the Utility Transmission Company's role after the divestiture of TEP's generation assets?

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A: TEP has considered the option of either keeping the utility distribution and transmission functions together in one company or separating them into two companies. At this point in time, we believe that the Commission's determination of the issues raised in this Track A portion as well as the Track B portion of this proceeding will have a significant impact on whether TEP ultimately decides to separate its distribution and transmission functions. Moreover, FERC's resolution of the WestConnect, L.L.C. ("WestConnect") approval filing will also impact that decision. If TEP decides to form a separate utility transmission company, that company would own and operate all of the transmission facilities currently owned by TEP. The utility transmission company would enter into arrangements with generators and the UDC for the transmission of electric power.

Q: What role would the utility transmission company play with regards to Regional Transmission Organizations ("RTOs")?

A: That depends on how the RTO is organized and operates. However, one of the reasons to keep the utility transmission company separate from the distribution company is the interaction that the transmission company will have with the FERC and RTOs. TEP is one of the founding members of WestConnect, which is a proposed western region RTO. I anticipate that the TEP utility transmission company will be an active participant in WestConnect or any other bona fide western region RTO.

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V. THE IMPACT OF TEP'S RECOMMENDATIONS FOR ELECTRIC COMPETITION OF THE TEP CODE OF CONDUCT AND AFFILIATE INTEREST RULES (A.A.C. R14-2-801, ET. SEQ.).

Q: Mr. Glaser, will you please review the status of TEP's Code of Conduct?

A: Yes. A.A.C. R14-2-1616 requires that TEP submit for Commission approval a Code of Conduct to govern transactions among and between TEP affiliates in connection with retail electric competition. The TEP Settlement Agreement also addressed the need for a Commission-approved Code of Conduct. TEP has filed and received approval for its Code of Conduct. The Code of Conduct deals with (1) the treatment of similarly situated persons; (2) use of confidential information; (3) use of bill and promotions within the bill envelope; (4) customer telephone calls; (5) prohibition on suggestion of utility advantage; (6) accounting for costs; (7) reporting requirements; (8) separation requirements; (9) transfers of goods and services; (10) joint marketing; (11) dissemination, education and compliance; (12) procedure to modify the code of conduct; and (13) dispute resolution.

TEP has also adopted Code of Conduct policies and procedures that have been approved by the Commission. These include (1) affiliate accounting policies; (2) access to information; (3) compliance; (4) contracting for personnel services between TEP and its competitive retail electric affiliates; (5) ESP contacts and requests for service; (6) joint promotion, sale and advertising with a competitive

retail electric affiliate; (7) physical separation of entities; (8) shared officers and directors; and (9) training policy.

Q: Does TEP believe that its Code of Conduct should be amended?

A: No, not at this time. I believe that the Code of Conduct adequately addresses the potential interaction among TEP affiliates under the present Electric Competition Rules and under TEP's proposal as outlined in Mr. Pignatelli's initial testimony. If, however, electric competition were repealed then TEP would reserve its right to withdraw the Code of Conduct and policies and procedures. If the Electric Competition Rules are materially changed, then TEP would reserve its right to submit for Commission approval a Code of Conduct and policies and procedures that are more relevant to the changed circumstances.

Q: Mr. Glaser, does TEP believe that the Commission's Affiliated Interest Rules should be amended at this time?

A: No, we are not proposing that the Affiliate Interest Rules be amended at this time. Although the Affiliate Interest Rules were not adopted specifically to meet the needs of electric competition, our review of those rules in the context of the Electric Competition Rules and our proposal for competition in the future leads us to conclude that they are appropriate as is. Similar to the Code of Conduct, I want to reserve our right to propose changes to the Affiliate Interest Rules in the event that the Electric Competition Rules are repealed or materially changed.

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Q: Does that conclude your initial testimony?

A: Yes it does.

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INITIAL TESTIMONY OF MICHAEL J. DECONCINI

TUCSON ELECTRIC POWER COMPANY

TRACK A ISSUES

May 29, 2002

INITIAL TESTIMONY OF MICHAEL J. DECONCINI
TRACK A ISSUES
May 29, 2002

I. INTRODUCTION.

Q: Please state your name and business address.

A: My name is Michael J. DeConcini. My business address is UniSource Energy Corporation ("UniSource"), One South Church, Tucson, Arizona 85702.

Q: What is your position with UniSource?

A: I am its Senior Vice President – Strategic Planning and Investments.

Q: What are your duties and responsibilities at UniSource?

A: I am responsible for overseeing our subsidiaries' involvement with wholesale electric markets, fuel contracts and supplies. I am also responsible for UniSource's strategic planning and overseeing its investment subsidiaries.

Q: Please provide a brief summary of your education and work experience.

A: I received a Bachelor of Science degree in Finance from Moorhead State University and a Masters of Business Administration degree from Arizona State University.

I joined Tucson Electric Power Company ("TEP") in 1988 and served there in various positions in finance, strategic planning and wholesale marketing. I was Manager of TEP's Wholesale Marketing department in 1994. In 1997 Product Development and Business Development were added to my responsibilities. I was elected Vice President, Strategic Planning of UniSource in February 1999. I was named Senior Vice President, Strategic Planning and Investments of UniSource in October 2000.

Q: What is the purpose of your initial testimony?

A: The purpose of my initial testimony is to:

1. Explain the role of the utility generation company after the divestiture of TEP's generation assets;
2. Describe the wholesale electric marketplace; and
3. Address several key market power issues related to competition and the wholesale markets.

II. THE ROLE OF THE UTILITY GENERATION COMPANY

Q: Mr. DeConcini, what are TEP's plans for divesting its generation assets?

A: Mr. Glaser, in his initial testimony, details the steps that TEP is preparing to take to divest its generation assets and transfer them to a new entity. TEP is investigating whether it is prudent to transfer its generation assets to more

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than one affiliate. Absent a change in the Electric Competition Rules or a variance to the Electric Competition Rules' requirement to divest generation assets, TEP will use its best efforts to complete the divestiture by December 31, 2002.

Q: After the divestiture, what role will the utility generation company have?

A: The utility generation company will own and operate generation assets and purchase electric power in the wholesale market. The utility generation company will sell electric power to wholesale purchasers such as UDCs, municipalities and cooperatives, and in some circumstances, may sell directly to Large Commercial and Industrial customers. I should note that the mix and management of these resources and loads is dependent on the outcome of this Track A and the Track B proceedings.

Q: In your opinion should utility generation companies be permitted to participate in the competitive solicitation process of their UDC affiliates?

A: Yes, I believe that they will be an important part of the competitive solicitation process and should be permitted to fully participate in competition. The Commission has enacted Affiliate Interest Rules and approved Codes of Conduct with policies and procedures to ensure that transactions between affiliates are at arms-length. If the Commission intends to implement meaningful and robust competition in the wholesale

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generation market, then it should not exclude utility generation companies from the competitive solicitation process of their affiliates. My opinion is based, in part, on my understanding of the current Electric Competition Rules and the TEP Settlement Agreement. My view may change depending on the outcome of the Track B proceedings and any subsequent changes to the percentages and timeframes of the competitive solicitation process as well as any revisions to the TEP Settlement Agreement.

III. THE WHOLESALE ELECTRIC MARKETPLACE

Q: Please describe TEP's involvement in the wholesale electric marketplace.

A: TEP's electric operations include the wholesale marketing of electricity to other utilities and power marketers. These wholesale transactions are made on both a firm basis and an interruptible basis. A firm basis means that contractually, TEP must supply the power (except under limited emergency circumstances), while an interruptible basis means that TEP may stop supplying power under various circumstances.

TEP typically uses its own generation to serve the requirements of its retail and long-term wholesale customers. Generally, TEP commits to future sales based on expected excess generating capability, forward prices and generation costs, using a diversified portfolio approach to provide a balance between long-term, mid-term and spot energy sales. When TEP expects to have excess generating capacity

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(usually in the first, second and fourth calendar quarters), TEP may enter into forward contracts to sell a portion of this forecasted excess generating capacity. Then, during the course of each month, TEP will analyze any remaining excess short-term generating capacity and make energy sales in the daily and hourly markets. TEP also enters into limited forward sales and purchases to take advantage of favorable market opportunities.

TEP anticipates that the utility generating company may be required to modify how it operates dependent upon the outcome of these proceedings and any subsequent changes to the Electric Competition Rules

Q: Please describe the types of sales that TEP transacts in the wholesale electric market.

A: TEP's wholesale sales consist primarily of three (3) types of sales:

1. Sales under long-term contracts for periods of more than one year. TEP has long-term contracts with three entities to sell firm capacity and energy:

   a) Salt River Project (SRP), expiring May 31, 2011, with a contract demand of 100 MW;

   b) Navajo Tribal Utility Authority (NTUA), expiring December 31, 2009, a full requirements contract with a typical high demand of approximately 50 MW in the summer and 90 MW in the winter; and

   c) Tohono O'odham Utility Authority (TOUA), expiring August 31, 2004, a full requirements contract with a typical high demand of less than 5 MW.

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TEP also has a long-term interruptible contract with Phelps Dodge Energy Services (PDES). This contract expires March 1, 2006 and requires a fixed contract demand of 60 MW at all times except during TEP's peak customer energy demand period, from July through September of each year;

2. Forward contracts to sell energy for periods through the end of the next calendar year. Under forward contracts, TEP commits to sell a specified amount of capacity or energy at a specified price over a given period of time, typically for one-month, three-month or one-year periods; and

3. Short-term economy energy sales in the daily or hourly markets at fluctuating spot market prices and other non-firm energy sales.

Q: What factors do you expect will influence the market price for electric power in the near future?

A: I expect the market price and demand for capacity and energy to continue to be influenced by continued population growth and economic conditions in the western U.S., the availability of capacity throughout the western U.S., the restructuring of the electric industry in Arizona, California and other western states, the effect of FERC regulation of wholesale energy markets, the availability and price of natural gas, precipitation, which affects hydropower availability; transmission constraints and environmental restrictions and the cost of compliance thereto.

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Q: Can you explain recent trends in the market price of electric power?

A: Let me explain by referring to the average market price for around-the-clock energy based on the Dow Jones Palo Verde Index.

The average market price for around-the-clock energy based on the Dow Jones Palo Verde Index fluctuated widely in 2001. It varied from an average of $156 per MWh in the first half of 2001 to an average of $23 per MWh in the fourth quarter of 2001. This reduction was due to a number of factors, including more generation online in the western U.S., smaller quantities purchased in the California spot markets, lower natural gas prices, increased hydro supply and weaker demand. As of February 2002, the average forward around-the-clock market price for the balance of 2002 was approximately $27 per MWh.

We cannot predict whether these lower prices will continue, or whether changes in various factors that influence demand and capacity will cause prices to rise again during the remainder of 2002. However, due to the increasing dependency on natural gas to fuel electric power plants, I expect that there will be a close correlation between the movement of gas and electric power prices. I also expect long term power prices to more fully reflect the total cost of new generation.

Q: Do you believe that in order for there to be meaningful retail electric competition in Arizona there must be an active wholesale electric power market?

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A: Yes, I believe that one of the elements that must be in place for meaningful retail electric competition is a properly functioning wholesale electric power market. I believe that the wholesale electric power market must operate on a regional basis. The most appropriate geographic region for Arizona to participate in would be the western region comprised of (at a minimum) Arizona, California, Nevada and New Mexico.

Q: What is your assessment of the development of the wholesale electric power market in the western region?

A: I think that there are differing opinions about the current status of the western region wholesale electric power market. I believe that the current power market is competitive at a wholesale level and that a competitive generation market can and will provide adequate generation resources. However, it is my opinion that certain key steps need to be taken in order to provide the opportunity for significant retail competition.

Q: Please identify the key steps that you have referenced.

A: Those steps are (1) addressing equal transmission access and relieving transmission constraints related to service of retail customers; (2) defining a clear transition plan to wholesale purchasing by UDC's and staying the course with such plan; (3) implementing of standard wholesale market rules; and (4) instituting effective wholesale market monitoring.

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Q: Please explain these steps in more detail.

A: I agree broadly with the positions that were taken by Commission Staff witness Mr. Jerry Smith, regarding equal transmission access and relieving transmission constraints, as stated in his direct testimony in the APS' Variance Request proceeding (Docket No. E-01345A-01-0822). I do not, however, believe that all significant transmission constraints must be eliminated for effective competition to exist.

The deficiencies of the California Power Market and its reliance solely on spot markets have brought to light the importance of a portfolio approach to the purchase of wholesale generation by the UDC. It is my opinion that the portfolio should consist of a mixture of long, intermediate, and short-term power purchases to provide less price volatility to standard offer customers as well as appropriate incentives to wholesale generators. The UDC purchase portfolio should consider the status and impact of retail competition and market comparables that customers may make thereunder as well as the typical factors such as load growth, customer contract terms, etc. TEP will address these and other competitive procurement issues in the Track B proceedings.

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I also believe that there should be well designed and tested market policies, procedures and rules and mechanisms in place for monitoring compliance therewith.

IV. KEY MARKET POWER ISSUES RELATED TO COMPETITION AND THE WHOLESALE MARKETS.

Q: Do you believe that retail electric competition can flourish in Arizona?

A: I agree with Mr. Pignatelli that factors such as an ESP's acquisition costs for Small Commercial and Residential customers being relatively high compared with the potential profit margin from these customers makes it very difficult for an ESP to establish a business plan in Arizona. And, with no other states in the Southwest having a firm plan in place to implement retail electric competition, it seems highly unlikely that ESPs will find retail electric competition in Arizona to be a viable business in the foreseeable future. Without entities willing to compete in Arizona, competition will not be a reality.

Q: Do you think that retail competition at any customer level is viable in the foreseeable future?

A: I believe that customers with energy requirements of three megawatts (3 MW) or greater could benefit in a competitive retail electric market. These Large Commercial and Industrial customers have the load characteristics

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and risk mitigation expertise that would attract suppliers at the wholesale level to serve their load. I believe that customers below the 3 MW threshold would be better off continuing to receive service from their incumbent utility under the existing tariffs or contracts. For example, if TEP's current customers under 3 MW remain on its system, this would insure that Residential and Small Commercial customers can receive the benefit of TEP's long term, low cost energy supply through 2008.

Q: Have any other states adopted similar limited provisions to retail competition?

A: Yes. It is my understanding that in April 2001, the State of Nevada repealed its electric restructuring legislation and is permitting large customers to procure electric power directly from generators, subject to Nevada Public Service Commission approval.

Q: In your opinion, what effects have recent events in the electric industry had on the wholesale electric power markets?

A: There is quite a list of events that have had an impact on wholesale electric power markets and electric competition. I think we are all still trying to determine the full scope of the lessons to be learned from California's attempt at electric restructuring. There has been a ripple effect throughout the electric industry from Enron's implosion. In addition, the numerous

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investigations into market manipulation and the delay and/or cancellation of electric competition in various jurisdictions are causing banks and investors to see the wholesale power business as a risky one. This perception of risk translates into less capital available for merchant power plants and higher capital costs. It appears that as a result of this reaction by the financial community numerous power plant project cancellations could cause a delay in developing the necessary infrastructure and lead to wholesale competition leveling off in the near-term.

Q: Does this conclude your initial testimony?

A: Yes, it does.

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