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BEFORE THE ARIZONA CORPORATION COMMISSION

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2003 APR 21 P 2:43

AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF)
THE ARIZONA ELECTRIC DIVISION OF)
CITIZENS COMMUNICATIONS COMPANY)
TO CHANGE THE CURRENT PURCHASED)
POWER AND FUEL ADJUSTMENT CLAUSE)
BANK, AND TO REQUEST APPROVED)
GUIDELINES FOR THE RECOVERY OF)
COSTS INCURRED IN CONNECTION WITH)
ENERGY RISK MANAGEMENT ACTIVITIES.)

DOCKET NO. E-01032C-00-0751

IN THE MATTER OF THE APPLICATION OF)
CITIZENS COMMUNICATIONS COMPANY,)
ARIZONA GAS DIVISION, FOR A HEARING)
TO DETERMINE THE FAIR VALUE OF ITS)
PROPERTIES FOR RATEMAKING PURPOSES,)
TO FIX A JUST AND REASONABLE RATE OF)
RETURN THEREON, AND TO APPROVE RATE)
SCHEDULES DESIGNED TO PROVIDE SUCH)
RATE OF RETURN.)

DOCKET NO. G-01032A-02-0598

IN THE MATTER OF THE APPLICATION OF)
CITIZENS COMMUNICATIONS COMPANY)
AND UNISOURCE ENERGY CORPORATION)
FOR APPROVAL FOR THE SALE OF CERTAIN)
ELECTRIC UTILITY AND GAS UTILITY)
ASSETS IN ARIZONA, THE TRANSFER OF)
CERTAIN CERTIFICATES OF CONVENIENCE)
AND NECESSITY FROM CITIZENS COMMUN-)
ICATIONS COMPANY TO UNISOURCE)
ENERGY CORPORATION, THE APPROVAL)
OF THE FINANCING FOR THE TRANS-)
ACTIONS AND OTHER RELATED MATTERS.)

DOCKET NO. E-01933A-02-0914
E-01032C-02-0914
G-01032A-02-0914

STAFF'S NOTICE OF FILING
JOINT STAFF REPORT

Staff of the Utilities Division ("Staff") of the Arizona Corporation Commission
("Commission") hereby files its Joint Staff Report in the above-captioned matters.

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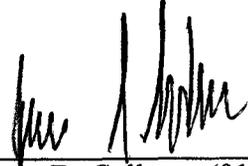
Arizona Corporation Commission

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1 RESPECTFULLY SUBMITTED this 21st day of April, 2003.

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STAFF REPORT

**CITIZENS COMMUNICATIONS COMPANY
UNISOURCE ENERGY COPORATION
SALE AND TRANSFER
GAS RATE CASE**

**DOCKET NOS. E-01032C-00-0751
 G-01032A-02-0598
 E-01933A-02-0914
 E-01032C-02-0914
 G-01032A-02-0914**

APRIL 21, 2003

EXECUTIVE SUMMARY

The Utilities Division Staff respectfully urges adoption of the Settlement Agreement reached between itself and UniSource Energy Corporation and Citizens Communications Company. It is a multi-faceted agreement which resolves numerous rate and regulatory issues in a manner that is fair to ratepayers.

It should be emphasized at the outset that in the sale and transfer transaction, UniSource effectively bargained for a purchase price significantly below the book value of the various electric and gas assets being transferred. Further, UniSource has agreed within the Settlement Agreement to pass the purchase price savings on to customers in ongoing and future regulatory procedures. Certain of the referenced savings included within the Settlement Agreement were originally included within the Joint Application filed by UniSource and Citizens with this Commission on December 6, 2003. Other additional concessions were negotiated with Staff and were subsequently included within the Settlement Agreement. The discounts to book value being achieved, and the savings inuring to ratepayers as a result of such discounts, can be viewed as the equivalent of, or analogous to, this Commission ordering significant plant and Purchased Power and Fuel Adjustment Clause disallowances following litigation of highly complex and controversial issues that address decisions made and actions taken by Citizens over a number of years.

The Settlement Agreement provides for an increase in the PPFAC factor as well as base gas rates. While the electric and gas increases included within the Settlement Agreement are not insignificant, they dwarf the exposure the ratepayers face through continued litigation of a number of issues at the ACC and appeals court level. Specifically, Staff urges the adoption of the Settlement Agreement in its entirety, without significant or substantive modification, for the following major reasons:

- In August 2002, Citizens filed for an annual increase in base gas rates of \$21.0 million (28.9 percent). Significantly, the noted Citizen base rate request filed in August 2002

was not “typical” of many energy filings which Citizens made during the 1990s wherein it repeatedly filed for much higher rates than ultimately proved justified. To the contrary, the August 2002 requested increase was premised primarily upon the near-tripling of rate base which has occurred since the last Citizens gas rate case filed in 1995. Specifically, over the last eight years, Citizens has added \$133 million in gross plant in service – with most of those expenditures related to an ACC-endorsed Build Out Program. As noted within the ensuing section, Staff’s analysis indicated that in all likelihood, Citizens acted imprudently in proceeding with certain elements of the Build Out Program without further study. Through a combination of 1) a discount-to-net-plant-book-value achieved in the purchase price of the gas plant (\$30.7 million) and 2) an additional \$10 million prudence disallowance ultimately acquiesced to by UniSource, the Settlement Agreement base rates being proposed for gas customers cumulatively reflect what would be equivalent to a \$40-plus million plant prudence disallowance – in this and all future rate cases. To emphasize the significance of such concession, it is noted that the removal of \$40-plus million of Citizens’ requested plant in service is equivalent to approximately one-third of all gas plant added by Citizens since it filed its last gas rate case in 1995.

- Customers will avoid a potential increase in their bills of over \$135 million from Citizens’ under-recovered PPFAC balance plus future carrying costs, because in the Settlement Agreement UniSource and Citizens will forfeit their rights to this under-recovered balance. The reduction to the electric rate base from the negative acquisition adjustment of approximately \$93.8 million should result in customers enjoying longer run avoidance of rate increases or, possibly, future rate reductions. Customers will experience stability in power costs included in the PPFAC for the next five years, and a guarantee of stability in total electric costs for the next three years related to the rate case moratorium. Further, if the Settlement Agreement is approved, electric customers should have the ability to choose alternative power suppliers in less than two years, and if customers find lower alternative power prices, they will be able to benefit from those prices without the burden of paying stranded costs. There will be an increase in the

PPFAC rate which will reflect only actual power costs after the date of the Decision, resulting in a new adjustor rate of \$0.01825 per kWh. However, UniSource is attempting to negotiate for lower power costs, and if successful, will pass on sixty (60) percent of any savings to customers pursuant to the Settlement Agreement.

- UniSource agreed to several limitations related to the financing of the sale and transfer of the gas and electric assets. First among these is if a loan from TEP to UniSource becomes part of the financing, the loan would be at a higher interest rate than UniSource originally requested, resulting in more interest income to TEP, ultimately benefiting TEP ratepayers. Second, the loan from TEP would be for four years rather than the ten years that UniSource originally requested, reducing the length of time that TEP's funds are at risk. Third, the Settlement Agreement places dividend restriction on the New Companies and tightens the current dividend restriction on TEP. This restriction was agreed upon to protect the earnings of the regulated Arizona utility from the possibility of failed ventures of the parent, UniSource. Finally, the Settlement Agreement contains a condition to hold TEP's ratepayers harmless from any increases in TEP's cost of capital as a result of the loan to UniSource. Taken together, these restrictions significantly reduce risk to the current TEP ratepayers and the ratepayers of the New Companies.

Staff respectfully urges the Commission to adopt the Settlement Agreement without significant modification. There may be elements that one would desire to change individually. Indeed, during negotiations, Staff at times bargained for different or additional concessions. However, the Settlement Agreement *taken as a whole* reasonably balances diverse interests, is fair to ratepayers and consistent with the public interest.

Ultimately, in Staff's opinion, the electric and gas rate increases being recommended for approval herein pursuant to the Settlement Agreement *are no higher than*, and in all likelihood, *lower than*, what would eventually have been allowed in the way of rate relief at the ACC or appellate court level. Staff would note that if the transaction is terminated because UniSource

simply cannot accept terms being suggested or imposed, and it withdraws from the transaction, that it is probable ratepayers will eventually be harmed. So, again, adoption of the Settlement Agreement as proposed, without significant modification, is recommended by the Utilities Division Staff.

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1 discussed, it would have been unreasonably cumbersome for Staff to negotiate with the Joint
2 Applicants with all other parties present. Therefore, Staff indicated that it would continue
3 negotiations with Citizens and UniSource and that the other parties should attempt to come to an
4 agreement with the applicants on an individual basis. On March 31st, Staff held a final meeting
5 with the intervenors explaining the main points of the proposed Settlement Agreement and
6 responded to the questions and concerns of the individual intervenors.

7
8 **Summary of the Benefits of the Settlement Agreement**

9 In later portions of this Report, Staff will detail the many benefits of the Settlement
10 Agreement. However, at the outset, we will summarize those benefits that are especially notable.
11 In general, Staff believes that a number of benefits would be difficult or impossible to achieve and
12 pass on to the ratepayers within the context of a normal rate case and sale of asset proceedings.

13
14 By far, the single most significant benefit is the “forgiveness” or permanent writedown of
15 the “under-recovered” purchased power costs included within the AED’s PPFAC bank balance at
16 the time of the closing of the asset purchase transaction. The current balance is \$124.0 million
17 and rising. It is estimated to reach at least \$135 million by July 28, 2003. The forgiveness of this
18 amount by UniSource saves the AED’s residential customers approximately \$12 per month.

19
20 The Settlement Agreement also includes a provision whereby the ratepayers will benefit
21 immediately if UniSource is able to renegotiate its purchased power contract with Pinnacle West
22 Energy. Pursuant to the Agreement, 60 percent of the savings from the renegotiated contract will
23 flow through to the ratepayers. In contrast, because Tucson Electric Power Company and

1 Arizona Public Service Company do not currently have a purchased power or fuel adjustor
2 mechanism in place, they are able to keep any savings from renegotiated power and fuel
3 contracts. Their customers would only receive such a benefit after a full rate case.

4
5 The Settlement Agreement will also benefit customers by the reduction of the requested
6 increase in gas rates from \$21.0 million as originally requested by Citizens (or UniSource's
7 original proposal contained within the Joint Application of \$16.6 million) to approximately \$15.2
8 million per the Settlement Agreement. The reductions result primarily from UniSource's
9 willingness to recognize the *purchase price* of the assets in rate base rather than the *book value* of
10 the assets. Additional reductions were achieved when UniSource agreed to a further \$10.0
11 million permanent agreed-upon disallowance from rate base and related depreciation expense due
12 to Build-Out Program excesses. Although in the past, the Commission has removed plant that
13 was not used or useful from rate base or deferred its recovery, it has not reduced rate base due to
14 the market value of a utility's assets. Thus, this voluntary, permanent reduction in rate base
15 would be unlikely outside of these dockets.

16
17 It is also problematic for a utilities commission to limit a utility's right to file for rate
18 increases. However, a three-year moratorium on the AED and AGD rates was achieved through
19 the Settlement Agreement.

20
21 Electric competition remains at the forefront of Arizona regulatory issues. The Settlement
22 Agreement contains a provision whereby within four months of approval of the Agreement,
23 UniSource will file a plan to open the AED's service territory to retail electric competition by

1 December 31, 2004. The Agreement, then, requires actions on the part of UniSource that may
2 accelerate the timing of the implementation of retail competition in the AEC territory. Electric
3 competition could be especially of great benefit to the Cities of Nogales and Kingman in reducing
4 the cost of electricity for their citizens.

5
6 Also related to the acceleration of electric competition in the AED territory, the issue of
7 stranded generation costs was addressed by the Settlement Agreement. Approval of the
8 Agreement will eliminate the time and expense of a separate proceeding. Pursuant to the
9 Settlement Agreement, UniSource agreed to permanently forgo recovery of any potential stranded
10 generation costs. It is doubtful that a separate proceeding could result in a more favorable result
11 for the ratepayers.

12
13 **The Sale of Citizens Arizona Gas and Arizona Electric Division Assets to UniSource**

14 The current purchase agreement to sell the AED to UniSource is not the first purchase
15 agreement entered into by Citizens to sell those assets. In May 2000, Citizens applied for
16 approval to sell the AED assets to Cap Rock Energy Corporation, a Texas-based electric
17 cooperative. The sales price in that transaction was \$210.0 million while the book value of the
18 assets was \$163.0 million resulting in an acquisition premium of \$47 million. The current
19 purchase price offered by UniSource is \$92 million while book value is \$187 million resulting in
20 an acquisition discount of \$93.8 million including the effect of transaction costs. It is reasonable
21 to assume that if Cap Rock had consummated the purchase, there would have been efforts to
22 recover the acquisition premium.

23 ...

1 Cap Rock was proposing to finance the acquisition with \$191.0 million of long-term debt
2 at approximately 9.0 percent interest and the remainder with preferred stock with a 12.0 percent
3 dividend rate. The transaction was subsequently cancelled when Cap Rock could not obtain
4 financing.

5
6 The proposed UniSource/Citizens transaction contrasts favorably with the Citizens/Cap
7 Rock transaction. Had the Commission approved the Cap Rock transaction, a financial burden
8 may have eventually been placed on the AED's rate payers related to CAP Rock's high financing
9 costs and large acquisition premium. The UniSource/Citizens transaction diminishes such risks.
10 Furthermore, UniSource is an Arizona-based holding company focused primarily on providing
11 utility service in Arizona. Both Cap Rock and Citizens are based in other states.

12
13 Another factor supporting the sale of the assets to UniSource is that since 1999, Citizens
14 has been trying to exit the electric and gas business. Its primary focus continues to be
15 telecommunications service. In contrast, UniSource continues to focus on and expand its energy
16 service.

17
18 The rest of this report will further detail, explain and support the various sections of the
19 Settlement Agreement. Staff strongly believes that it is in the public interest for the Commission
20 to adopt the settlement agreement and approve the three applications at issue.

21 ...

22 ...

23 ...

1 Out Program represents a *permanent* write down to plant in service that will result in
2 savings in future Arizona gas base rate proceedings as well as in the instant case.

3
4 • Base rates will not be changed for a three-year period barring a) an emergency condition,
5 or b) a material change in cost of service attributable to a select set of events that are
6 beyond the control of UniSource.

7
8 • The base rate increase is being proposed to be spread evenly among all retail rate classes.
9 Further, for residential customers, the customer charge is being established at \$7.00 per
10 month. While such change represents a fairly significant percentage increase from the
11 current monthly customer charge of \$5.00 a month for the Northern Arizona Gas Division
12 (“NAGD”) and \$5.26 for the Santa Cruz Gas Division (“SCGD”), it is significantly below
13 the Citizens-proposed monthly charge of \$10.00 per month, as well as Citizens’ cost-of-
14 service justified customer charge of \$15.99 per month. Further, rates for the NAGD and
15 the SCGD have been consolidated for this case and all future cases.

16
17 • A new base cost of gas of \$0.400 per therm is being rolled into base rates. This larger
18 base roll-in amount should produce lower future PGA factors and billing values while
19 better reflecting higher recent and ongoing gas cost levels.

20
21 In the ensuing sections, we provide a history of events, a discussion of analyses
22 undertaken, a listing of concerns and issues identified as a result of analyses undertaken, as well

1 as a discussion of why Staff believes the Settlement Agreement regarding gas rate and accounting
2 issues is “in the public interest.”
3

4 **Gas Rate Case Background**

5 On August 6, 2002, Citizens Communications Company (formerly known as “Citizens
6 Utilities Company”) filed a base rate application that sought to increase Arizona retail base gas
7 rates by \$21,005,521. The requested increase equated to an average overall increase of 28.9
8 percent for all retail customers. Further, with its filing Citizens sought to combine, or consolidate,
9 its Northern Arizona Gas and Santa Cruz Gas Divisions’ operations for rate or tariff purposes.
10

11 The August 2002 filing was the first Citizens gas base rate filing made since October 18,
12 1995. Citizens’ 1995 filing culminated in a relatively modest \$2.7 million (6.0 percent) increase
13 in the Northern Arizona Gas Division’s rates. Significantly, during the nearly eight-year span
14 since Citizens’ last Arizona gas rate case, the Company invested approximately \$133 million in
15 gas plant. This significant investment in gas plant is the primary contributor to the near-tripling
16 of rate base that Citizens was requesting within its August 2002 rate filing versus what had been
17 requested within its 1995 gas rate case. As discussed in a separate section below, the majority of
18 Citizens’ plant additions during the noted eight-year period is attributable to the Company’s
19 Arizona Build Out Program – a program designed to expand Citizens’ gas service to relatively
20 remote, low density and high-cost-to-serve areas.
21

22 Because of the size and complexity of Citizens’ 2002 base rate filing, in conjunction with
23 other regulatory projects which were straining the internal resources of the Utilities Division

1 Staff, a request for proposal to undertake most major elements of the review of Citizens' rate
2 filing was issued. Upon review and receipt of various bidders' proposals to undertake the
3 requested rate review, the Utilities Division Staff issued a contract to the consulting firm of
4 Utilitech, Inc. Utilitech had undertaken the rate review of numerous Citizens rate applications in
5 Arizona as well as Hawaii throughout the 1990s. The Utilitech contract was awarded in early
6 December 2002 with the initial review work and issuance of substantial discovery commencing
7 almost immediately upon contract award.

8
9 On December 19, 2002, UniSource and Citizens filed the Joint Application which is now
10 the subject of this Staff Report. With the filing of the noted Joint Application, Staff's review
11 (including the various analyses being undertaken by contractor Utilitech) was modified and
12 expanded to include consideration of how the Arizona properties' gas cost of service might
13 change as a result of the UniSource acquisition. Such tasks were undertaken in addition to the
14 original task of determining an appropriate revenue level assuming continued Citizens ownership
15 of such Arizona gas properties.

16
17 It should be noted that the acquisition of the Arizona gas properties is not envisioned by
18 UniSource to result in significant "overhead" or other "economies of scale" savings that
19 frequently occur when utility properties are sold or merged with larger entities. To the contrary,
20 as the "acquirer," UniSource is a smaller entity than Citizens which has historically owned energy
21 properties in a number of jurisdictions. There is expected to eventually be some savings from the
22 operation of the contiguous *electric* properties – but these savings are expected to be relatively
23 modest. Thus, the "savings" which UniSource projects, and which were incorporated within the

1 revised and downwardly-adjusted Arizona gas base rate request included within the noted Joint
2 Application, is premised almost entirely upon the reflection of the negative acquisition
3 adjustment. As noted previously, the negative acquisition adjustment has materialized as a result
4 of UniSource's acquisition of the Citizens gas properties significantly below the net depreciated
5 original cost book value.

6
7 **Summary of Citizens' August 2002 Base Rate Application**

8 During the 1990s, Citizens filed several rate applications with the ACC to increase retail
9 electric and gas rates. Citizens' rate requests could be broadly characterized as "aggressive,"
10 typically proposing a significantly larger increase than ultimately proved to be justified. In fact,
11 through much of the 1990s, Citizens obtained through negotiated settlements or ACC orders in
12 contested cases, increases that represented a relatively small fraction of various initial Citizens
13 requests. Utilizing such historical Citizens rate case results as a benchmark, the settlement rates
14 being recommended herein may, at first glance, appear "excessive."

15
16 However, Citizens' August 2002 gas rate application can be distinguished in many
17 respects from the "typical" rate request undertaken throughout the 1990s. Specifically, in the
18 August 2002 rate application Citizens has not reflected any of the following cost of service
19 positions that it frequently promoted, but failed to obtain ACC approval for, during the 1990s:

- 20
21 • Construction Work in Progress ("CWIP") in Rate Base: Throughout the 1990s Citizens
22 frequently sought to include CWIP within its rate base request. Such requests were made

1 notwithstanding universal rejection by the ACC. In the instant case, Citizens has not
2 proposed to include any CWIP in rate base.

3
4 • Weather Normalization: Citizens typically did not post a “weather normalization”
5 adjustment in cases filed during the 1990s. In the instant case, Citizens proposed an
6 adjustment to normalize for weather even though such adjustment had the impact of
7 *lowering* its requested rate increase.

8
9 • Year End Customer Annualization: Adjustments to recognize growth in revenues related
10 to growth in number of customers through test year end were seldom proposed by
11 Citizens in cases filed in the 1990s – even though such adjustments were routinely
12 accepted by the ACC in Citizens as well as other Arizona utility rate orders. Citizens did
13 post a year-end customer annualization in the instant case – consistent with prior ACC
14 precedent.

15
16 • Post-Test Year Expense Adjustment: Citizens was notorious for proposing adjustments
17 to recognize *post test year* expense *increases*, while ignoring offsets in other expense
18 areas or post-test year growth in revenues. In the instant case, Citizens undertook a better
19 job of “matching” test year revenues and expense levels.

20
21 • Administrative Offices Expense: Throughout the 1990s, the ACC was critical of
22 a) certain charges being allocated from Citizens’ various administrative offices, as well as
23 b) the high level and seemingly duplicative nature of the various administrative office

1 expenses being assigned/allocated to Arizona utility properties. In this case, Citizens did
2 a very thorough job of removing administrative office expenses that the ACC had
3 previously disallowed, and furthermore, “capped” the total administrative office expense
4 level to the amount found acceptable *in the 1993 rate case (i.e., \$1.2 million)*. In other
5 words, Citizens has capped its administrative offices expense to a level found reasonable
6 by the ACC nearly a decade ago.

- 7
- 8 • Depreciation Expense: In the 1990s, Citizens occasionally sought to *increase* its
9 depreciation rates for energy properties owned in Arizona. In the instant case, Citizens
10 has proposed to *reduce* its Arizona gas depreciation rates. Further, Staff found the
11 depreciation study presented by Citizens in this case to be well documented employing
12 assumptions generally thought to be reasonable.

13

14 In short and in sum, the Citizens application made in August 2002 is not “typical” of the
15 rate filings it made throughout the 1990s inasmuch as a much more balanced test year approach is
16 being proposed. Further, Citizens incorporated many ACC-adopted adjustments that it had
17 routinely fought and lost throughout the 1990s. Thus, the very significant increase being
18 proposed by Citizens within its August 2002 rate filing was being justified primarily by the
19 significant dollars the Company had invested within the Arizona Build Out Program. Its
20 requested increase was not being significantly “exaggerated” by reflection of the many
21 adjustments it had previously proposed – and which the ACC routinely rejected – in rate
22 applications occurring throughout the 1990s.

1 **Arizona Build Out Program**

2 As noted previously, the investment which Citizens made in the Build Out Program over
3 the previous eight years was, by far, the largest element driving Citizens' significant gas rate
4 request. In order to understand the Staff's view of the Settlement Agreement, it important to
5 understand the history and experience of Citizens' Arizona Build Out Program.

6
7 Thus, by way of background, in 1991, Citizens acquired the Certificate of Convenience
8 and Necessity and natural gas transmission and distribution facilities in Northern Arizona from
9 Southern Union Company. In Decision No. 57647, the ACC approved the asset purchase subject
10 to certain restrictions and obligations that it placed upon Citizens. These included a requirement
11 that Citizens submit a long-term plan "of at least five years" to the Director of the Utilities
12 Division concerning extension of service in the certificated area, and an obligation to extend gas
13 service to areas where "it is economically feasible to do so."

14
15 In 1993, Citizens filed a general rate case application that included a "1993-1997 Build
16 Out Plan" wherein Citizens proposed to spend approximately \$53 million in capital improvements
17 over a five-year period in order to ultimately extend service to an additional 20,000 potential
18 customers. The plan included reinforcement of the existing infrastructure for the then-current
19 customers, as well as the necessary expenditures for pipeline mains and service lines to extend
20 natural gas service to homes and businesses in portions of the Northern Arizona Gas Division's
21 service area that did not have service. At that time, Citizens estimated that the required
22 expenditures would more than double the Company's investment in gas plant facilities in
23 Northern Arizona.

1 Within the 1993 rate application, Citizens requested unique rate treatment that would
2 allow it to surcharge customers taking service in previously unserved areas. Additionally,
3 Citizens sought unique accounting authority to defer or capitalize carrying costs on portions of the
4 Build Out Program investment even after elements were placed into service. With minor
5 exception, the ACC authorized Citizens' surcharge and accounting authority requests.

6
7 In 1995, Citizens filed its next general rate case application for the Northern Arizona Gas
8 Division. Within the 1995 rate filing, Citizens described the status of the Build Out Program,
9 including some of the problems being encountered. Citizens indicated within the 1995 filing that
10 it remained committed to the Build Out Program, but that completion of the program would be
11 delayed until at least 1998.

12
13 The 1995 general rate case was finalized with a settlement agreement between Citizens,
14 the Arizona Corporation Commission Staff, the Residential Utility Consumer Office, and the
15 Arizona Community Action Association. The Commission issued Decision No. 59875 approving
16 the settlement agreement. Neither the settlement agreement nor the Commission Order made any
17 reference to the reported status or announced extension of the Build Out Plan. The decision did
18 require that the surcharge established within the 1993 rate case (Decision No. 58664) should be
19 revisited within Citizens' next general rate case, but in any event, should not continue beyond the
20 completion of the Build Out Program. As the Build Out Plan proceeded, the delays and
21 difficulties experienced in extending service continued and the Program extended well beyond the
22 anticipated 1998 completion date projected within the 1995 rate filing.

1 Several important observations should be noted when considering the history of the Build
2 Out Program and the ACC's actions regarding such program:

- 3
- 4 • The concept of the Build Out Plan was initially supported by the ACC within its Order
5 approving the Citizens acquisition of the Southern Union Gas Company Arizona gas
6 properties. It was again endorsed by the ACC within the 1993 rate case Order (Docket
7 No. 58664) which approved unique rate and accounting treatment for the capital intensive
8 construction program.
 - 9
 - 10 • While the ACC was initially and subsequently supportive of a Build Out Plan, it was
11 always with the understanding and intent that construction program cost to serve new
12 customers/areas should not be heavily subsidized by "existing customers."
 - 13
 - 14 • The Build Out Program occurred at a much slower pace, and at a much higher cost, than
15 what was originally anticipated when presented to the ACC by Citizens in Docket
16 No. 58664.
 - 17

18 Observing the tremendous investment that Citizens had made in the Arizona Build Out
19 program, and the significant impact that such investment was having upon the cost of service
20 which the Company was presenting within its August 2002 rate application, the Utilities Division
21 Staff undertook an investigation designed to answer a number of questions and concerns,
22 including – but not necessarily limited to – the following:

23

- 1 1. How does the final cost of the Build Out Program compare to the original estimates
2 presented to the ACC in the 1993/1994 time frame?
3
- 4 2. How much of the Build Out Program costs were incurred to be able to safely and reliably
5 serve *existing* Citizen service territories (for which there would be a continuing obligation
6 to serve) and how much were incurred to serve new territories not previously served (and
7 for which there would be no obligation to provide *uneconomic* service)?
8
- 9 3. What were the major causes of the Build Out Program cost overrun?
10
- 11 4. Of the major causes of the Build Out Program cost overrun, how many were within the
12 control of Citizens?
13
- 14 5. How much, if any, of the Build Out Program cost, was imprudently incurred?
15
- 16 6. Did it remain "economical" to serve new territories given the higher-than-originally
17 projected Build Out Program costs?
18
- 19 7. Will Citizens customers taking service prior to the Build Out Program end up *significantly*
20 subsidizing newly acquired customers taking service in previously unserved territories?

21 In an attempt to answer the above-listed as well as other corollary questions, numerous
22 written discovery questions were submitted, numerous Build Out Program studies and documents
23 were reviewed, and two separate interviews with Citizens' NAGD Vice President and General

1 Manager, Gary Smith, were undertaken. Several important observations were made as a result of
2 this review process.

3
4 First, by and large, the significant cost overruns incurred were as a result of a combination
5 of events including 1) underestimation of costs originally presented to the ACC, 2) new
6 environmental regulations and new governmental construction requirements, not in effect at the
7 outset of the Build Out Program, drove up construction costs significantly from that originally
8 projected, 3) unforeseen rock caused the installation costs to be multiples of that initially
9 anticipated for certain areas of the Build Out Program, 4) the Company became responsible for
10 installation and maintenance of services located on customers' property [at the time the Build Out
11 Program was first contemplated, customers were responsible for the installation and cost of
12 services located on customer property] and 5) changes in right-of-way requirements not in effect
13 at the outset of the Build Out.

14
15 In addition to costs not foreseen at the outset of the Build Out Program, the economics of
16 the program have also suffered as a result of fewer customers signing up for service in new
17 service territories, and fewer conversions to natural gas service from electric or propane service,
18 than was originally envisioned near the outset of the program.

19
20 In general, Staff's investigation has led to a conclusion that the cost overruns experienced
21 were largely out of the control of Citizens management. The one possible exception to this
22 conclusion is that Staff questions whether additional geological surveys should have been

1 undertaken prior to embarking upon construction in areas that ultimately contained significant
2 amounts of rock that had to be sawed through at extremely high costs.

3
4 While not highly critical of the cost overruns experienced, Staff's investigation has lead to
5 a significant concern regarding Citizens' failure to re-evaluate the economics of serving certain
6 new territories as it experienced changing high cost governmental and environmental
7 requirements, and as it experienced installation costs much higher than originally projected as a
8 result of hitting rock that had not been anticipated. Specifically, the Staff is critical of Citizens for
9 not re-evaluating the Build Out to the Pinetop-Lakeside, Camp Verde and the Village of Oak
10 Creek communities. If Citizens had not sold its Arizona gas properties to UniSource at a
11 significant discount to book value, *and* if UniSource had not agreed to pass such purchase price
12 savings on to retail gas customers, it is almost a certainty that significant issues would have been
13 presented to this Commission in the Citizens gas rate case regarding the Company's decision to
14 proceed with the Build Out Program in certain high-cost-to-serve areas in the face of much-
15 higher-than-originally-forecasted capital costs and lower-than-forecasted-customer growth.

16
17 As previously noted, UniSource negotiated a purchase price for plant in service being
18 acquired which is significantly below the net plant in service value included within Citizens'
19 proposed gas rate base. While one will not observe any connection between the \$30.7 million
20 negative acquisition adjustment and the cost overruns of the Build Out Program in the
21 UniSource/Citizens Asset Purchase Agreement, in the view of the Utilities Division Staff, the two
22 events are very much connected. Specifically, the Staff notes that throughout the 1990s utility
23 properties were typically sold at a *significant premium* above net depreciated original cost book

1 value. Further, in those cases, the acquiring utilities frequently sought direct or indirect rate
2 recovery of the *premium* they were paying.

3
4 UniSource's acquisition of the Arizona gas properties *at a discount to net depreciated*
5 *original cost book value* is very unusual. Further, UniSource's settlement proposal to *reflect the*
6 *negative acquisition adjustment in rate base in this and future Arizona rate proceedings, is also*
7 *highly unusual.* Whether or not the discount to book value achieved in the purchase price was, in
8 the collective minds of UniSource management, related to Build Out Program cost overruns is not
9 known. What the Utilities Division Staff unequivocally states herein is that it believes the
10 negative acquisition adjustment should be considered as being attributable to the Build Out
11 Program cost overruns. In other words, the negative acquisition adjustment for the gas properties
12 can be viewed as the equivalent to a "rate case disallowance" that may have occurred had Citizens
13 continued owning the Arizona gas properties and the issue of the "imprudence" of the decision to
14 continue the Build Out Program in the face of changing conditions had been presented within the
15 Citizens rate case filed with the ACC in August 2002.

16
17 While the Utilities Division Staff was cognizant of, and indeed appreciative of,
18 UniSource's voluntary reflection of a \$30.7 million *permanent* negative acquisition adjustment in
19 the current as well as future Arizona rate cases, it did not immediately accept such adjustment as
20 the appropriate and only equitable remedy for the Build Out Program cost overruns. To the
21 contrary, the Utilities Division Staff negotiated for *another \$10 million permanent gas plant*
22 *disallowance attributable to the Build Out Program.* This further permanent Build Out Program
23 disallowance is described within Paragraph No. 36 (b) of the Settlement Agreement.

1 Thus, between UniSource's voluntary reflection of a \$30.7 million *permanent* negative
2 acquisition adjustment, and the Company's further concession as discussed at Paragraph No. 36
3 (b) of the Settlement Agreement to another \$10 million write down of Build Out Program costs,
4 rates are being established under this Settlement Agreement based upon a plant in service value
5 that is more than \$40 million under that which was reflected within Citizens' rate base proposal
6 embodied within its August 2002 rate application.

7
8 Before leaving the topic of the Build Out Program-related write down and the negative
9 acquisition adjustment, a brief discussion of the accounting and future rate impact of these
10 transactions are in order. First, as discussed with Paragraph No. 35 of the Settlement Agreement,
11 the negative acquisition adjustment will be initially recorded within FERC Account No. 114-Gas
12 Plant Acquisition Adjustments. After the transaction is completed, the balance in FERC Account
13 No. 114 will be transferred to FERC account No. 108 – Accumulated Provision for Depreciation
14 of Gas/Electric Utility Plant. The Company will then establish separate sub-accounts to FERC
15 Account No. 108 to record an allocation of the total negative acquisition adjustment to each
16 FERC plant-related account. The amortization of the negative acquisition adjustment shall be
17 recorded as a debit to FERC Account No. 108 and a credit to FERC Account No. 406 –
18 Amortization of Gas/Electric Plant Acquisition Adjustment. The *credit* amortization to Account
19 No. 406 represents a *negative* expense. Inasmuch as the original cost of all electric and gas plant
20 in service will remain in FERC Account No. 101 Gas/Electric Plant in Service, and be depreciated
21 over the life of such plant, the *negative* amortization expense recognized in FERC Account No.
22 406 will exactly offset the related depreciation expense on original cost gas/electric plant found in
23 FERC Account No. 101 and being charged to FERC Account No. 408. *The net result of this*

1 *perhaps somewhat confusing accounting jargon is that the unamortized balance of the negative*
2 *acquisition adjustment will be reflected as a rate base reduction in all future rate cases until such*
3 *time that such balance is fully amortized. Further, the negative amortization expense charged to*
4 *FERC Account No. 406 will ensure that ratepayers will never pay depreciation expense on the*
5 *original cost of plant that has been reduced for ratemaking purposes by the negative acquisition*
6 *adjustment.*

7

8 With regard to the \$10 million prudence disallowance related to the Build Out Program
9 discussed at Paragraph No. 36 (b) of the Settlement Agreement, UniSource has agreed to a
10 permanent write down of the \$10 million disallowance directly against original cost plant in
11 service. The noted write down directly to plant in service will ensure that ratepayers will never
12 pay a return on, or a return of (i.e., depreciation), such permanently disallowed plant amounts.

13

14 Several important points regarding the Build Out Program should be summarized and
15 emphasized. As noted, Staff is critical of Citizens for proceeding with the build out without
16 further study to certain areas that turned out to be extremely high cost to serve. However, many
17 of the construction projects included within the Build Out Program were incurred to serve
18 territories *for which Citizens already had an obligation to serve*. Further, some of the pipe
19 installed served a dual purpose of reinforcing existing service territories as well as enabling
20 growth to previously unserved areas. If the Settlement Agreement is not approved, and if the
21 Citizens August 2002 rate filing is litigated under a continued-Citizens-ownership scenario, it
22 promises to be a complex and highly controversial case. Staff will have some legitimate
23 criticisms of the Build Out Program to present. Conversely, Citizens will argue that prior to, and

1 during the Build Out Program, it had ACC support – if not an ACC mandate – to go forward with
2 the program. Further, since as noted, some of the pipe installed served the dual purpose of
3 reinforcing the existing system as well as facilitating growth in new areas, quantification of a
4 definite “imprudence” disallowance will prove somewhat subjective and no doubt highly
5 controversial. In the final analysis, given the history and facts surrounding the program, it is
6 difficult to envision an “imprudence” disallowance under a continued-Citizens-ownership
7 scenario that will approach or exceed the cumulative value of the negative acquisition (i.e., \$30.7
8 million *and* the additional \$10 million prudence disallowance considered in the development of
9 the settlement rates. For this as well as other reasons set forth throughout this report, the Staff
10 strongly recommends that the Commission adopt the Settlement Agreement as presented.

11
12 **Other Cost of Service Adjustments**

13 Within the Joint Application filed by Citizens and UniSource on December 19, 2002,
14 among other things, UniSource proposed to increase annual Arizona base gas rates by
15 \$16,645,370, or some 22.92 percent. Thus, the UniSource proposed increase was significantly
16 less than the Citizens filed rate request of \$21,005,521. The largest adjustments posed by
17 UniSource within the cost of service it presented within the December 19, 2002, Joint Application
18 to arrive at its proposed \$16.7 million increase was the noted \$30.7 million negative acquisition
19 adjustment to rate base, as well as the attendant reduction in depreciation expense on the negative
20 acquisition adjustment (\$827,246). However, other smaller rate base and operating expense
21 adjustments proposed by UniSource within the December 19th Joint Application have also been
22 incorporated within the agreed upon gas cost of service used in establishing the stipulated rate
23 increase. Briefly, we identify and describe the need for such other minor adjustments.

1 First, the Accumulated Deferred Income Taxes recorded on Citizens' balance sheet as of
2 the end of the 2001 historic test year have been eliminated from rate base consideration in
3 developing the settlement rates. Upon consummation of the purchase, there will initially be no
4 difference between "book" and "tax" plant records. The Accumulated Deferred Income Taxes
5 which are on Citizens' books and records will be extinguished upon completion of the sale – and
6 will not be transferred to UniSource. Accordingly, it was necessary and equitable to eliminate
7 this item from rate base consideration in the instant case. As UniSource begins to depreciate its
8 acquired utility plant for tax purposes at an accelerated pace to that being recognized for book and
9 regulatory purposes, this rate base offset will again be established and proceed to grow. In future
10 rate cases, the Accumulated Deferred Income Tax balance accrued upon UniSource's books and
11 records will again be reflected as a rate base offset.

12
13 Second, in its August 2002 rate application, Citizens had proposed to utilize the Gains on
14 Sales of two of its Arizona office buildings as a rate base offset. Further, consistent with past
15 ACC precedent, Citizens proposed to amortize one-half of the gains from each sale over a five
16 year period. Inasmuch as these "gains" have not been transferred to UniSource through the
17 purchase transaction, such Gains on Sale have been removed from rate base and operating income
18 development employed in the design of the settlement rates being proposed.

19
20 Third, still with regard to rate base development, UniSource had proposed to eliminate the
21 "negative cash working capital" allowance that had been reflected within Citizens' rate base
22 proposal. UniSource argues that following the acquisition, it will – at least for a while – have an
23 investment in working capital that Citizens did not. This UniSource position is questionable and,

1 in any event, probably temporary. Staff challenged this adjustment in settlement discussions, but
2 ultimately did not oppose its recognition in light of the immateriality of the item and in
3 recognition of the “overall” benefits of the settlement proposal.

4
5 Fourth, UniSource voluntarily removed the amortization of gas rate case expense that had
6 been reflected within Citizens’ proposed cost of service development. This \$165,000 reduction in
7 expense has also been reflected within the settlement rates being recommended herein.

8
9 Fifth, the net revenue reduction resulting from other adjustments discussed above also had
10 a corollary effect on bad debt expense. This reduction reflected within UniSource’s December
11 19th Joint Application is also reflected within the settlement rates being recommended herein.

12
13 Finally, UniSource has proposed a different mix of capital, at different cost rates, than that
14 proposed by Citizens within its August 2002 rate application. While the “after-tax” rate which
15 UniSource has proposed (9.05 percent) is slightly higher than the “after-tax” rate included within
16 Citizens’ August 2002 application (8.85 percent), on a “before-tax” or “revenue requirement”
17 impact basis, UniSource’s cost of capital proposal results in a *lower* revenue requirement, as
18 illustrated in the calculations below:

19 ...
20 ...
21 ...
22 ...
23 ...

1 **Citizens' Cost of Capital Proposal**

2

Description	Capital Ratio	Cost Rate	Weighted Cost	Tax Conversion Factor	Before-Tax COC
Equity	.5000	11.00%	5.50%	1.665640	9.161%
Long Term Debt	.5000	6.70%	3.35%		3.350%
Total	1.000		8.85%		12.511%

3
4 **UniSource's Settlement Cost of Capital**

5

Description	Capital Ratio	Cost Rate	Weighted Cost	Tax Conversion Factor	Before-Tax COC
Equity	.4000	11.00%	4.40%	1.665640	7.329%
Long-Term Debt	.6000	7.75%	4.65%		4.650%
Total	1.000		9.05%		11.979%

6
7 As can be gleaned from the table above, Citizens' higher equity ratio assumption – with its
8 attendant tax ramifications – causes its proposed “true” or “before-tax” cost of capital to be higher
9 than that being utilized in the development of rates being proposed within the Settlement
10 Agreement. Further, we note that Citizens had lowered the common equity return that it thought
11 to be justified in light of the significant increase it was requesting within its August 2002 rate
12 filing. Specifically, Citizens presented testimony that purported to justify a 12.0 percent return on
13 equity, but reflected only an 11.0 percent return on equity within the development of its retail cost

1 of service study. As noted on the table above, the Settlement Agreement rates continue to reflect
2 the 11.0 percent return on equity first proposed by Citizens.

3
4 Earlier, it was noted that Citizens' August 2002 rate application was much *less aggressive*
5 than those which the Company had proposed throughout the 1990s. Specifically, Citizens
6 voluntarily abandoned many issues and posted many adjustments that it had previously lost in
7 prior Arizona rate proceedings. Thus, it is fully expected that, but for the Build Out Program
8 issues, relative to Citizens cases litigated during the 1990s, there would be far fewer issues, with
9 much smaller dollar values, if the Citizens gas case were to proceed under a continued Citizens
10 ownership assumption scenario.

11
12 The Utilities Division Staff considered the presentation of a number of smaller dollar
13 revenue requirement issues in its negotiations with Citizens. However, ultimately the Utilities
14 Division Staff determined, and is strongly urging herein, that adoption of the one significant
15 *permanent* \$10 million Build Out Program adjustment in lieu of a small number of one-time or
16 case-specific adjustments be accepted in the interest of reaching a total *overall* settlement on gas
17 rates, as well as other elements of this multi-faceted agreement. As noted within the prior section,
18 the gains for ratepayers vis-à-vis reflection of the negative acquisition adjustment and the \$10
19 million Build Out Program prudence disallowance represent significant *permanent* savings for
20 ratepayers that Staff does not believe is likely achievable in a rate case under a continued-
21 Citizens-ownership scenario.

22 ...

1 **Rate Spread and Rate Design**

2 The rates being proposed for each affected gas rate class are reflected on Appendix B –
3 Schedule 3 to the Settlement Agreement. The rate increase was spread to rate classes on the basis
4 of total retail gas revenues – inclusive of purchased gas cost. This rate spread is slightly more
5 beneficial to residential users than would be a rate spread based upon “non-gas” cost revenues.

6
7 We also note that the Settlement Agreement provides for a uniform set of base rates to be
8 applicable to what was formerly the Northern Arizona Gas and Santa Cruz Gas Divisions. The
9 proposal to consolidate the rates of the two noted divisions was included within recommendations
10 incorporated within Citizens’ August 2002 rate application. The consolidation of tariffs had the
11 impact of slightly lowering the increase that would have been generated in the Santa Cruz
12 Division on a separate cost of service basis. In other words, if rates would have continued to have
13 been based upon separate divisional cost of service studies, the Santa Cruz Division would have
14 received a slightly higher rate increase in the instant case. Under the settlement rates being
15 proposed, UniSource will absorb the slight revenue shortfall between the recommended
16 settlement rates and the rates that would have been designed for Santa Cruz on a divisional stand
17 alone cost of service basis.

18
19 Under the settlement rates being recommended for approval, the residential customer
20 charge will be raised from the current Northern AGD \$5.00 per month charge and current Santa
21 Cruz AGD \$5.26 per month charge to \$7.00 per month. Citizens had proposed a residential
22 customer charge of \$10.00 per month, and had presented unit cost of service study information
23 which purported to show a cost-justified residential customer charge of \$15.99 per month. We

1 further note that the residential customer charge being established pursuant to the Settlement
2 Agreement is somewhat below the current Southwest Gas Company customer charge of \$8.00 per
3 month.

4
5 We also note that the current SCGD residential and small commercial tariffs employ a
6 complex multi-stepped commodity rate. Under the proposed tariff, the multiple commodity steps
7 will be replaced with one flat commodity rate. The impact of collapsing the multiple stepped
8 commodity rates for the Santa Cruz Gas Division is that some extremely low volume gas users
9 will experience an increase that is higher than the overall average increase being experienced by
10 the entire residential rate class. However, the Settlement Agreement provides that the CARES
11 discount program will be made available in the Santa Cruz Gas Division for the first time. Thus,
12 to the extent the low volume users require financial assistance in paying their utility bills, the
13 CARES program will be available to them.

14
15 The Small Volume Commercial monthly customer charge is being raised from \$7.50 to
16 \$11.00. Citizens had proposed that the Small Volume Commercial customer charge be
17 established at \$13.00 per month, and presented cost of service studies that indicated that the Small
18 Volume Commercial monthly customer charge should be \$16.46 per month.

19
20 **Purchase Gas Adjustor ("PGA")**

21 As noted within Paragraph No. 26 of the Settlement Agreement, the cost of purchased gas
22 being rolled into base rates for all Arizona gas properties is \$0.400 per therm. Inasmuch as base
23 rates for the Northern Arizona and Santa Cruz Gas Divisions are being consolidated, it logically

1 and consistently follows that PGA base gas costs should be implemented on a consistent Arizona-
2 wide basis. Further, Citizens' projections reflect no significant difference in the expected
3 delivered cost of gas for the two systems. Finally, while purchased gas costs have been volatile
4 and difficult to predict, the \$0.400 per therm roll-in price appears to be appropriate, or perhaps a
5 bit conservative, when compared with recent actual gas price experience as well as predicted
6 future prices. Ultimately, the actual purchased gas roll-in amount will not affect customers' total
7 bills, it only affects how much will be recovered within "base rates" versus how much will be
8 surcharged or credited with implementation of a PGA factor.

9
10 **PGA Bank Balance**

11 The Settlement Agreement establishes within Paragraph No. 36 (a) that the Commission
12 will not challenge the Company's gas accounting and procurement practices affecting the PGA
13 bank balance existing on or before October 29, 2002. However, recent and ongoing gas
14 purchases, as well as the Company's procurement practices, remain subject to ACC review.

15
16 **Revised Line Extension Tariff and Policy**

17 Appendix D to the Settlement Agreement reflects the revised Line Extension Tariff being
18 proposed by the parties. Citizens' currently-effective Line Extension Tariff provides for a 100
19 foot allowance per potential new customer for main extensions to be installed at the Company's
20 cost. Specifically, under the current Citizens Line Extension Tariff, if more than 100 feet per
21 customer is to be installed to be able to serve a new area or subdivision, the customers are to be
22 assessed a prorata charge for the new main line based upon the number of feet needed in excess of
23 the 100 feet per average customer that is being installed at the Company's expense. Additionally,

1 the existing Line Extension Tariff provides that the Company will install the gas service line from
2 the distribution main to the customer's property, and up to 60 feet on the Company's property, at
3 its expense -- regardless of cost. Further, to the extent a customer requires more than 60 feet of
4 service line to be installed up his property, such service line installed in excess of 60 feet will be
5 reimbursed by the customer at a cost rate of \$8.00 per foot.

6
7 The proposed Line Extension Tariff shown on Appendix B limits the Company's main
8 extension cost to 30 feet per new customer agreeing to utilize a gas hot water heater or a furnace.
9 To the extent that more than 30 feet of main extension is required, the customer will be assessed a
10 charge for the cost of the main extension in order to make the investment "economic" from the
11 Company's and existing customers' point of view. The proposed Line Extension Tariff also
12 provides for new customers to pay the cost for the service line installed by the Company on the
13 customer's property. The provisions in the proposed Line Extension Tariff better ensure that
14 existing customers will not significantly subsidize the higher costs being incurred to serve new
15 customers. Further, the Line Extension Tariffs being proposed within the Settlement Agreement
16 is very similar to the Line Extension Tariffs approved by this Commission for Southwest Gas
17 Company.

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ELECTRIC PURCHASED POWER AND FUEL ADJUSTOR CASE ANALYSIS

Major Agreements Reached with Regard to Citizens Arizona Electric Properties

The Settlement Agreement provisions which will substantially affect the AED customers when they become customers of the UniSource electric subsidiary (“ElecCo”) are:

- Customers will not see any increase in the PPFAC rate from the portion of the under-recovered PPFAC balance related to the Old Contract (\$87 million plus requested carrying costs) because UniSource and Citizens will forfeit their rights to this under-recovered amount.
- Customers will also avoid any increase in the PPFAC rate costs resulting from the under-recovered PPFAC balance related to the New Contract (\$48 million plus requested carrying costs). These costs have accumulated since the time the New Contract went into effect (June 2001) and will accumulate up to the date of closing of the asset sale. UniSource and Citizens have agreed to forfeit their rights to this amount.¹
- Customers will enjoy long-term reductions in or avoidance of rate increases based upon the permanent reduction to the electric rate base in future rate cases due to the negative acquisition adjustment of approximately \$93.8 million.

¹ If closing occurs after July 28, 2003, this amount will be larger than \$48 million.

- 1 • Customers will experience stability in power costs for the next five years (the remaining
2 life of the New Contract).
- 3
- 4 • Customers will have the ability to choose alternative power suppliers in less than two
5 years because the Settlement Agreement requires that the service territories for the present
6 AED/the future ElecCo be open to retail electric competition by December 31, 2004.
- 7
- 8 • If customers find lower alternative power prices, they will be able to benefit from those
9 prices without the burden of stranded costs.
- 10
- 11 • An incentive in the Settlement Agreement provides for electric customers to receive sixty
12 (60) percent of any savings as a result of any successful renegotiations with Pinnacle West
13 Capital Corporation (“PWCC”) of the New Contract.
- 14
- 15 • The increase in electric rates will reflect only future actual power costs, resulting in a new
16 adjustor rate of \$0.01825 per kWh.
- 17

18 In Summary, customers will be better off under the Settlement Agreement than under any
19 of the expected outcomes of the PPFAC case.

20

21 **Electric PPFAC Case Background**

22 The Settlement Agreement and acquisition by UniSource of Citizens electric assets will
23 resolve all issues from Citizens’ PPFAC case, Docket No. E-01032C-00-0751, in which Citizens

1 requested major changes to its PPFAC. Citizens had originally requested full recovery of the
2 under-recovered balance for purchase power costs that Citizens incurred. These costs were
3 mainly due to a contract signed between Citizens and APS in 1995 (hereinafter referred to as the
4 Old Contract). Citizens had requested a rate increase to collect the under-recovered balance
5 (approximately \$87 million as of June 2001) over a seven-year period. Citizens also requested
6 recovery of all purchased power costs related to a new agreement that was negotiated between
7 Citizens and PWCC effective June 1, 2001 (hereinafter referred to as the New Contract), plus a
8 six (6) percent carrying charge for the under-recovered balance from the Old and New Contract.
9 This total under-recovery is projected to be at least \$135 million by July 28, 2003. In addition,
10 Citizens requested an increase in the adjustor rate from \$0.000 per kWh to \$0.01825 per kWh to
11 accommodate the costs of purchased power under the New Contract, as well as to reflect
12 increased transmission costs.

13
14 The foregoing requests, taken together, would have resulted in an adjustment factor
15 sufficient to cover the costs of the New Contract plus the total amount projected to be under-
16 recovered as of July 2003 (plus future carrying costs) of approximately \$.0320 per kWh .

17 ...

18 The major issues in the PPFAC case were whether Citizens should be allowed to collect
19 all of its under-recovered balance, and whether costs under the New Contract should be fully
20 recoverable. While there was no order in the PPFAC case, it is likely that the Commission's
21 decision would have been influenced by the positions supported by the Company, by Staff, and by
22 others. The Company requested recovery of its under-recovered PPFAC balance over seven years

1 with a carrying cost charge of 6 percent. Staff's proposals, which are discussed in section B
2 below, would have resulted in a larger increase than will result from the Settlement.

3
4 The largest portion of the PPFAC under-recovered balance resulted from Arizona Public
5 Service Company ("APS") bills under the Old Contract, from the summer of 2000 through May
6 of 2001. Citizens is primarily a distribution utility, and has purchased most of its power from
7 APS/PWCC under a FERC-approved wholesale contract. The increase in the PPFAC adjutor
8 was intended to address, in addition to power costs, increases in transmission costs resulting from
9 system growth, and the replacement of the wholesale contract with a new contract.

10
11 **The Old Contract**

12 The Old Contract with APS contained nominal "rates" for demand and energy, under three
13 different schedules, for baseload, intermediate, and peaking power. However, the contract also
14 included "floor price" provisions which became the basis for pricing. The floor price was defined
15 by APS' System Incremental Cost ("SIC"). As explained below, there was a dispute between
16 Citizens and APS as to the precise definition and role of the SIC in determining what and how
17 APS could charge Citizens for purchased power under the Old Contract.

18
19 APS did not own enough generating plant capacity itself or through its Pinnacle West
20 subsidiary to meet APS' full load requirements, including its retail plus wholesale load (Citizens
21 was included in the wholesale load). APS made up what would have been a shortfall by
22 purchasing "on the market", from others that had excess generation to sell. APS interpreted the
23 SIC provision in the contract as allowing APS to charge Citizens the highest cost of market power

1 that it purchased every hour, while Citizens believed the SIC referred to only certain lower cost
2 purchases. This difference in interpretation did not become evident when purchase power costs
3 were low. However, beginning in May of 2000, market price increases for purchased power
4 caused Citizens' bills under the Old Contract to increase dramatically, such that the PPFAC and
5 the amount of power costs recovered in base rates did not recover billed power costs.

6
7 Citizens, in its testimonies in support of its request for an increase in its PPFAC, indicated
8 that, based on Citizens' interpretation of the SIC provisions, it believed APS had misinterpreted
9 the SIC and other terms of the contract, and that Citizens' own interpretation of the contract
10 would have resulted in lower power costs and a much lower under-recovered balance. However,
11 in the PPFAC case before the Commission, Citizens indicated that it had no plans to appeal to the
12 FERC for an interpretation of the contract that might have reduced power costs and, therefore, its
13 under-recovered balance.

14
15 **Terms of New Contract**

16 The New Contract, which took effect June 2001, supplanted the old contract and contains
17 a very simple and stable pricing mechanism. The price of power was set at a fixed rate of
18 \$0.05879 per kWh for generation costs.² The New Contract has a seven-year term starting June 1,
19 2001 and is with Pinnacle West Corporation ("PWCC"), APS' parent. Furthermore, the New
20 Contract only requires Citizens to purchase power for those customers who purchase power from
21 Citizens (as evidenced in the definition of "Buyer's Full Load Requirements" in Exhibit A to the

² Line losses between delivery to Citizens and delivery to its customers mean that the cost to customers is about 10 percent higher than this value. Citizens indicated that its transmission costs had increased because it had signed a contract with additional transmission capacity necessary to serve load growth in Mohave County.

1 contract³), whereas the Old Contract required that Citizens purchased fixed amounts of power.
2 This means that Citizens and its successor will be able to allow customers choice of generation
3 supplier with no stranded costs.
4

5 **Staff Proposals in the PPFAC Case Prior to the Joint Application**

6 In the PPFAC proceeding, Staff faulted Citizens' management of its power costs on a
7 number of issues. Staff's recommendations would have resulted in a reduction of the allowed
8 recovery from that requested by the Company, and might have resulted in a reduction of the
9 under-recovered total amount.⁴ Staff's recommendations also would have resulted in an
10 elimination of carrying costs on the under-recovered balance. However, even if Staff's
11 recommendations were accepted by the Commission, the result would have been that customers
12 would have been asked to pay some significant amount toward the existing under-recovered
13 balance.
14

15 Staff recommended an immediate and complete disallowance of \$7 million of the under-
16 recovered power costs. Staff argued that Citizens should be required to defer collection of the
17 amount of dollars for which it had made claims that it had been over billed (as much as \$70
18 million) because of APS' misinterpretation of the Old Contract, until it had made every effort to
19 obtain relief from FERC or the courts. So, while the requested disallowance of \$7 million and of
20 carrying costs might have been ordered by the Commission, the final result of Staff's other
21 recommendations would not have been known, because the results would depend on findings by

³ There are certain exceptions that would allow Citizens to purchase some additional power, but these are extremely limited, including purchases from the Department of Energy for Aha Macav, and purchases necessary for reliability purposes.

1 the FERC. In short, the customers of the AED could still have been assessed this additional \$70
2 million depending on the outcome at FERC. The Settlement Agreement eliminates this
3 uncertainty via the forfeiture by UniSource of the entire under-collected amount discussed above.
4

5 With regard to the New Contract, Staff criticized the process by which the Company
6 analyzed and committed to this contract. Staff did not argue that the New Contract itself was
7 imprudent, but rather suggested that the Commission should consider the New Contract in a
8 further proceeding. However, Staff expected that there would be some significant increase in
9 power costs, since electric prices were higher than the amount of power costs in base rates.
10

11 Reducing power costs below those resulting from the New Contract would have been
12 difficult. First, modifying the contract would have been extremely difficult, given that it had been
13 approved by FERC. Any disallowance or imprudence finding would certainly have been
14 appealed, delaying resolution still further. Second, even if Citizens had defaulted on this contract,
15 it would have had to find a replacement contract or contracts; and given the chaotic state of the
16 western power market in the last two years, no assurance existed that a less expensive power
17 source could have been found. In short, the price of purchased power in the New Contract might
18 have appeared high but was not unreasonable given the volatile and expensive electricity
19 environment that existed at the time the New Contract was negotiated. The Settlement
20 Agreement will ensure that two years of under-recovered costs due to the New Contract would
21 not be collected from electric customers, leaving at a maximum five years of higher purchased
22 power costs under the New Contract.

⁴ If FERC agreed that APS had overcharged Citizens.

1 At the present time, there are only five years remaining on the New Contract. While the
2 price for purchased power under the New Contract, viewed in late 2001, might have seemed
3 somewhat high, the same price is a better price today and for the next four years. Although the
4 Western power market has settled down, gas costs, which are crucial in determining electric
5 market prices, are distinctly higher than they were in 2001, and electric prices have been rising
6 over the last year.

7
8 It is Staff's opinion that the lowest cost resolution from a Commission decision regarding
9 the New Contract, from a ratepayer standpoint, would not have resulted in more than a 25 percent
10 disallowance of the under-recovered amount resulting from the New Contract. It also seems
11 unlikely that the Commission would have ordered Citizens to default on the contract. Thus, we
12 expect that the PPFAC case would have resulted in an increase in the PPFAC adjustor to cover
13 the New Contract, in addition to some increase related to the under-recovered balance directly
14 resulting from the New Contract.

15
16 **What the Settlement Agreement Should Be Compared to for Electric Customers**

17 The result of the Settlement Agreement should be compared to the rates that customers
18 would have been paying without the sale and transfer, and particularly without the Company
19 having given up the claim to the estimated amount of at least \$135 million of the under-recovered
20 balance as of July 28, 2003, plus carrying costs of more than \$18 million, which would have
21 brought the total to almost \$154 million. Although we cannot know for certain what the exact
22 resolution of the PPFAC case would have been, it is clear that it would have resulted in an

1 increase in power costs and customer bills significantly above what is contemplated in the
2 Settlement Agreement.

3
4 **Alternatives With and Without the Sale and Transfer**

5 The Settlement Agreement includes approval of a new adjustor rate of \$0.01825 per kWh
6 due to purchase power costs resulting from the New Contract with PWCC. The rate provisions of
7 the New Contract are very simple, including only a single per kWh charge throughout the life of
8 the contract, currently at seven years from June 1, 2001. Approval of the Settlement Agreement
9 will result in approval of the Company's collecting the ongoing costs of this contract. The new
10 PPFAC adjustor increases electric rates for the customers of ElecCo by approximately twenty-two
11 (22) percent. However, as discussed above, the impacts to rates and electric customers would
12 likely be significantly higher if not for the Settlement Agreement. Furthermore, several
13 provisions exist in the Settlement Agreement to further mitigate and minimize the impact of the
14 new adjustor rate, as will be discussed with more specificity in the section on rate impacts, below.
15 While there is less certainty regarding what customers would have paid if the sale and transfer
16 and Settlement had not occurred, the following sections discussed the more likely outcomes, if the
17 PPFAC case proceeded to a hearing.

18
19 When considering the impact of the increase in rates that would result from the New
20 Contract, we should keep in mind that Citizens' customers have been paying the same rates since
21 the fall of 2001, and rates that were only slightly lower for a number of years. Thus, during a
22 period in which power prices in the West in general went haywire, and the customers of most
23 other utilities experienced some level of price increase, Citizens' customers have had stable rates.

1 **Potential Outcomes**

2 If the Settlement Agreement had not been proposed, customers would have been faced
3 with an increase in the PPFAC to cover some amount of under-recovered PPFAC balance, and
4 also to cover higher ongoing power costs.

5
6 To make a judgment about the Settlement Agreement, it is useful to compare the various
7 potential outcomes directly.

- 8
- 9 • Settlement Agreement – no recovery of under-recovered amounts from either the Old or
10 New Contracts with increase in ongoing power costs from the date of closing.
 - 11
 - 12 • Worst case without Settlement – Company’s request for under-recovered amount from
13 Old and New Contract (estimated to be at least \$135 million as of July 28, 2003), plus
14 future carrying costs, and all costs associated with the New Contract, is approved.
 - 15
 - 16 • Best case without Settlement– Citizens takes the contract dispute to FERC, and FERC
17 finds in its favor, reducing the under-recovery from the Old Contract by \$70 million;
18 Commission orders 25 percent denial of the under-recovery from the New Contract.
- 19

1 Rate Impacts of Potential Outcomes

Impact on Different Alternatives on Customers of Citizens AED

Customer Rate Class	Current	Settlement	Worst	Best
Residential MO	\$/kWh			
	\$ 0.082	\$ 0.101	\$ 0.114	\$ 0.105
	Average Annual Bill			
	\$878	\$1,073	\$1,219	\$1,116
	% Increase			
	22%	39%	27%	
Residential SC	\$/kWh			
	\$ 0.088	\$ 0.107	\$ 0.120	\$ 0.111
	Average Annual Bill			
	\$687	\$829	\$936	\$861
	% Increase			
	21%	36%	25%	
Small General Service MO	\$/kWh			
	\$ 0.084	\$ 0.102	\$ 0.116	\$ 0.106
	Average Annual Bill			
	\$1,122	\$1,367	\$1,551	\$1,422
	% Increase			
	22%	38%	27%	
Small General Service SC	\$/kWh			
	\$ 0.128	\$ 0.147	\$ 0.160	\$ 0.151
	Average Annual Bill			
	\$1,080	\$1,233	\$1,349	\$1,268
	% Increase			
	14%	25%	17%	
Large General Service	\$/kWh			
	\$ 0.080	\$ 0.099	\$ 0.112	\$ 0.103
	Average Annual Bill			
	\$20,162	\$24,743	\$28,195	\$25,774
	% Increase			
	23%	40%	28%	
LPS (<69kv)	\$/kWh			
	\$ 0.074	\$ 0.092	\$ 0.106	\$ 0.096
	Average Annual Bill			

	\$1,321,433	\$1,646,777	\$1,891,872	\$1,719,987
	% Increase			
		25%	43%	30%
LPS (>69kv)	\$/kWh			
	\$ 0.060	\$ 0.078	\$ 0.092	\$ 0.082
	Average Annual Bill			
	\$2,024,186	\$2,642,155	\$3,107,696	\$2,781,212
		% Increase		
		31%	54%	37%

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Customers will be better off under the Settlement Agreement than under any of the expected outcomes of the PPFAC case. On average, customers' rates will be lower by about 12 percent for the next seven years under the Settlement Agreement than they would have been under the Company's PPFAC proposal. Also, there is a provision in the Settlement Agreement that encourages UniSource to renegotiate the price of purchased power under the New Contract with APS/PWCC. This provision of the Settlement Agreement further provides that customers will receive 60 percent of the savings associated with any reduced price of purchase power under the New Contract. UniSource is currently attempting to renegotiate with APS/PWCC.

Other Long-term Rate Impacts on Electric Customers

In addition to minimizing the impact on electric customers by eliminating the under-recovered balance through the date of closing, and providing significant savings to electric customers if the New Contract purchase power price is renegotiated, the Settlement Agreement includes provisions designed to convey long-term benefits. Specifically, these include provisions regarding a reduction in the electric rate base, a commitment not to increase base rates for at least three years, and a possible consolidation of operations.

1 The negative acquisition premium of \$93 million has the effect of removing half of the
2 electric system's rate base. This will reduce the return and depreciation component of rates by
3 about \$15 million, reducing the electric revenue requirement by this amount. This will be to the
4 electric ratepayers' benefit in future ElecCo rate cases. This reduction in the return will offset
5 increases in other system costs, either delaying when a rate case can be filed or reducing the
6 amount requested.

7
8 The commitment to not file for an increase in base rates for three years means that even if
9 costs might justify an increase, even after the rate base reduction, the Company will not file a rate
10 case during this period. This may delay the next possible increase in rates.

11
12 In addition, the Settlement Agreement requires TEP to develop a feasibility study
13 regarding the consolidation or coordination of the operations of ElecCo in Santa Cruz County
14 with the operations of TEP. Consolidation or coordination has the potential of increasing
15 efficiencies of system control and engineering, possibly lowering costs, and increasing reliability
16 in the region.

17
18 **Value of Retail Access**

19 The Settlement Agreement includes a provision that TEP commits to establishing a
20 process for opening up the new ElecCo's territories to retail competition by December 31, 2004.
21 In the Settlement Agreement, UniSource agrees that stranded costs resulting from retail access
22 shall be zero. This is implicit in the New Contract but this Settlement Agreement term provides
23 additional customer protection. Since there will be no stranded costs, if there are lower cost

1 power providers available, there will be one less obstacle to customers changing their generation
2 provider from ElecCo to less expensive providers. This term is the ultimate reality check on the
3 New Contract. If the New Contract is priced above market prices, customers will be able to
4 escape its terms by choosing alternative suppliers.

6 ANALYSIS OF FINANCING OF THE SALE AND TRANSFER OF UTILITY ASSETS

8 Background of Financing Issues

9 Sections 16 through 20 of the Settlement Agreement address a range of financing issues
10 that arose in the application. These sections of the Settlement Agreement permit the New
11 Companies to fund themselves through issuances of debt and equity. The debt issuances are
12 limited to \$175,000,000. The equity issuances are limited to \$125,000,000. Overall, the target
13 capital required for the transaction is approximately \$250,000,000.

15 The Loan from TEP to UniSource

16 According to the Settlement Agreement, TEP can loan up to \$50,000,000 for no more than
17 four years to UniSource for the purpose of funding the acquisition. UniSource would then infuse
18 the entire sum and other equity that it raises into either HoldCo (the new subsidiary formed by
19 UniSource to hold the stock of the New Companies) or the New Companies as an equity
20 investment. The TEP loan to UniSource will be secured by 100 percent of HoldCo's or the New
21 Companies' equity. The loan will bear an interest rate of 383 basis points above the rate on an
22 equivalent US Treasury security. The Settlement Agreement also provides that 264 basis points
23 of the interest income will be deferred as a credit to customers. The deferral will reduce TEP's

1 rates in the future (as an offset to rate base and expense). The remaining interest income from the
2 loan is committed to build up TEP's equity capitalization. Increasing TEP's equity capitalization
3 from its currently low levels is in ratepayers' interest because the increase improves TEP's
4 financial health and ability to provide service.

5
6 The 383 basis-point spread is based on the spread between BB-rated four-year energy debt
7 and the yield on a four-year US Treasury security. A BB rating is appropriate for the loan
8 because the loan should be priced according to UniSource's risk, a company that is currently
9 unrated. Staff's assumed BB rating is appropriate because it reflects a below-investment-grade
10 rating.

11
12 **Hold Harmless Provision**

13 The Settlement Agreement contains a condition to hold TEP's ratepayers harmless from
14 any increases in TEP's cost of capital as a result of the \$50 million loan. The hold-harmless
15 provision on TEP's cost of capital provides some assurance that ratepayers will be held harmless
16 and that TEP bear the burden to prove mitigating factors if the \$50 million loan is shown to have
17 harmed TEP's cost of capital.

18
19 **Waiver of the 30 Percent Condition**

20 The Settlement Agreement waives a condition of Commission Decision Nos. 60480 and 62103.
21 That condition, as amended, requires UniSource to invest 30 percent of all new equity proceeds
22 directly in TEP. The Settlement Agreement waives the 30 percent condition for the purpose of
23 financing this particular acquisition. The waiver is needed so that UniSource can invest all new

1 equity proceeds in the New Companies (via HoldCo) without diverting proceeds to TEP. The
2 waiver is reasonable given the need to seek equity for utility-related businesses whose acquisition
3 is in the public interest.

4
5 **Dividend Payout Restrictions on TEP and the New Companies**

6 The Settlement Agreement imposes a condition on the New Companies such that they are
7 restricted from paying more than 75 percent of their earnings out in dividends as long as their
8 capital structures contain less than 40 percent equity. These restrictions are beneficial to
9 ratepayers of the New Companies because they restrict the percentage of earnings that can be paid
10 out as dividends to HoldCo when equity capitalization falls below 40 percent. Retaining a certain
11 amount of equity is important for a utility in order to provide service.

12
13 The Settlement Agreement also modifies a previous condition of Commission Decision
14 No. 60480. Currently, TEP is ordered to pay no more than 75 percent of its earnings out in
15 dividends as long as it has less than 37.5 percent equity capitalization. The Settlement Agreement
16 increases the 37.5 percent threshold to 40 percent. This modification enhances existing TEP
17 ratepayer protection because it raises the hurdle below which TEP is restricted in paying
18 dividends to its parent UniSource.

19
20 **Guarantee of Affiliate Debt**

21 The issue of TEP's guaranteeing UniSource or other affiliates' debt did not arise in this
22 case: no guarantee authority was requested. The circumstances in this case are different from
23 recent cases in which APS requested authority to lend funds to, or guarantee debt of, affiliates. In

1 those cases, APS requested authority to support an unregulated affiliate that operated in the
2 merchant energy market along with competitors. Two concerns, amongst others, arose in those
3 cases: regulated utility support of a competitive merchant operation and risk to the regulated
4 utility. This case presents entirely different circumstances because the loan is ultimately going to
5 support regulated operations serving captive customers. In this case, TEP would not be
6 supporting a competitive merchant operation and would not be exposed to the risk of the
7 merchant energy market. Therefore, the question whether the public interest would be better
8 served through a guarantee versus through a loan is effectively not issue in this case.

10 CONCLUSION

11 Staff believes that the Settlement Agreement is the result of a fair negotiation process and
12 that intervenors were given adequate opportunity for input and to sign the Settlement Agreement
13 or to arrive at their own agreement with UniSource and Citizens. Staff negotiated the Settlement
14 Agreement in good faith and with both the short and long-term interests of the rate payers at
15 heart.

16
17 In conclusion, Staff believes that the benefits of the forgiveness of the large under-
18 recovered PPFAC balance, the three-year rate moratorium for both electric and gas operations, the
19 significant permanent reductions to rate base related to the purchase of the Citizens assets at a
20 price below book value and Build Out Program disallowances far outweigh the rate and adjustor
21 factor increases that are included in the Settlement Agreement. The Settlement Agreement
22 relieves ratepayers from exposure to even higher rates now and in the future that may have
23 resulted from litigation at the Commission or appellate court level. Finally, Staff believes that the

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- 1 Settlement Agreement reasonably balances diverse interests, is consistent with the public interest
- 2 and should be adopted by the Commission.