LEWIS AND ROCA LLP
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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner

WILLIAM A. MUNDELL
Commissioner

MIKE GLEASON
Commissioner

JEFF HATCH-MILLER
Commissioner

Arizona Corporation Commission
DOCKETED

APR 28 2003

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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 RATE, TO ESTABLISH A NEW PURCHASED POWER AND FUEL ADJUSTMENT CLAUSE BANK, AND TO REQUEST APPROVED GUIDELINES FOR THE RECOVERY OF COSTS INCURRED IN CONNECTION WITH THE ENERGY RISK MANAGEMENT INITIATIVES.	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 PROVED SUCH RATE OF RETURN.	DOCKET NO. G-01032A-02-0598

LEWIS AND ROCA LLP

LAWYERS

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

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

NOTICE OF FILING REBUTTAL TESTIMONY

Notice is given that the Joint Applicants are filing the rebuttal testimony of Steven Glaser, Michael J. DeConcini and Kevin P. Larson in support of their Joint Application for approval of the sale of Citizens Communications' Arizona gas and electric business to UniSource and related approvals.

Respectfully submitted this 28th day of April, 2003.

LEWIS AND ROCA LLP

By [signature]
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1393701.1

ORIGINAL AND seventeen (17) copies
of the foregoing hand-delivered
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Arizona Corporation Commission
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Phoenix, Arizona 85007

COPY of the foregoing hand-delivered
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REBUTTAL TESTIMONY OF STEVEN GLASER
UNISOURCE ENERGY CORPORATION

APRIL 28, 2003

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Steven Glaser. My business address is 4350 E. Irvington Road, Tucson, AZ 85714.

Q. Did you file direct testimony on behalf of UniSource Energy Corporation ("UniSource") in this Docket?

A. Yes. I filed direct testimony on December 18, 2002.

Q. What is the purpose of your rebuttal testimony?

My testimony addresses proposed modifications to the Settlement Agreement as recommended in the testimony of the Residential Utility Consumer Office ("RUCO") witness, Ms. Marylee Diaz Cortez.

Q. What recommendations did Ms. Diaz Cortez propose in her testimony?

A. Although RUCO was supportive of the Settlement Agreement, Ms. Diaz Cortez did propose the following changes: (1) modify allocation of any savings that may be realized in a Pinnacle West Capital Corporation ("PWCC") contract renegotiation from 60/40 percent to 90/10 percent for Customer/UniSource, respectively; and (2) increase expenditures for Demand Side Management ("DSM") programs from the current level of $175,000 per year to $600,000 and potentially to $1,000,000 per year.

Q. With regards to how savings that result from a potential renegotiation of the PWCC contract are allocated, would you consider a change from a 60/40% sharing to a 90/10% sharing reasonable?

A. No, it is not reasonable to make such a significant change to a single component in the Settlement Agreement.

Q. Why do you believe that such a request is unreasonable?

A. The proposed settlement that has been reached was the culmination of many discussions and bargaining regarding multiple issues. To change a single component, rather than viewing the settlement as a whole, would upset the balance achieved by the parties in the settlement process. As in most complex negotiations, throughout the negotiations, the parties weighed the issues and where acceptable, compromised positions initially taken in order to reach agreement. One needs to look no further than the content of the Joint Application and the elements of this Settlement Agreement to find examples. UniSource conceded to numerous modifications including: (1) a $10 million permanent reduction to the gas rate base; (2) restrictions in the financing provisions; and (3) a three-year gas and electric rate moratorium. (This is particularly noteworthy because Citizens' base electric rates have not been increased since January 1997.)

This settlement as a whole benefits Citizens' customers in substantial ways. Citizens' electric customers will not be asked to pay for any increases in power costs through the closing of this transaction, because UniSource has agreed to forfeit its right to pursue the undercollected Purchase Power and Fuel Adjustor Clause ("PPFAC") balance from the Citizens customers. This amount is estimated to be approximately $135 million by the end of July 2003. A further benefit of the settlement is that Citizens' gas customers will have use of approximately $30.7 million of facilities and Citizens' electric customers will have use of approximately $93.6 million of facilities that they will never have to pay for because UniSource has agreed not to seek recovery of the negative acquisition adjustments.

Rather than looking at a single component of the proposed settlement in a vacuum, the overall significant beneficial outcome should be the key consideration. Therefore, I urge the Commission to view the 60/40 percent PWCC contract savings allocation as part and parcel of the entire settlement package.

Q. What are your concerns regarding RUCO's proposal that the funding of DSM be increased significantly?

A. DSM programs help customers to use energy more efficiently, which should help them reduce their power bills. This is a worthwhile goal; however, in recent years, there have been some significant differences of opinion as to the best way to assist consumers with this endeavor. As I will discuss, the Commission will be providing further direction on these issues in the near term. Therefore, to significantly increase the amount of funds Citizens is currently working with for DSM programs is premature.

Q. How has DSM policy evolved over time?

A. DSM gained momentum in the electric utility industry in the early 1990's. Early DSM programs were focused on offering rebates to consumers who purchased energy efficient electric equipment. For the past five to seven years, the utility industry in Arizona has shifted the DSM focus from rebate programs to market-based solutions, such as TEP's Guarantee Home Program and renewable energy resources. Moreover, in the Commission's Environmental Portfolio Standard ("EPS") order, Decision No. 62506, the Commission has supported the renewable energy approach and authorized Arizona utilities to shift funding from DSM programs to renewable energy resources.

Q. Why did the industry shift to market-based DSM programs?

A. One reason for the shift is that most rebate programs only create short-term changes in behavior, while market-based solutions and consumer education programs result in long-term behavioral changes (market transformation). Market-based solutions are driven by customer choice, given the combination of the customers' particular circumstances based on load patterns, awareness and economics. Over the years, the Commission has expressed an interest in moving to market-based DSM programs. For example, in TEP's last general rate case, Decision No. 59594, in a settlement between TEP, Staff, RUCO, and others, the parties agreed to a shift in DSM focus from rebate programs to self-funded, market-based solutions. We believe that market-based solutions are driven by customer economics, thus reducing the need for additional subsidization of DSM programs through a charge on a consumer's bill.

Q. How much is Citizens currently collecting in rates for DSM program costs?

A. Citizens' original proposal in its last electric rate case was a DSM program to be funded $800,000 annually. However, in Decision No. 59951, the Commission approved $175,000 annually for on-going DSM program costs. In addition, Citizens received approval to collect $200,000 annually for previously deferred DSM costs. Currently there is approximately $1,000,000 remaining in the deferral account.

Q. Generally, how has the Environmental Portfoloio Standard decision affected DSM funding?

A. TEP and Arizona Public Service ("APS") have shifted dollars from DSM funding to meet the EPS requirements. In its Decision, the Commission found:

- The Affected Utilities should utilize existing SBC (System Benefit Charges) monies to fund the EPS; and

- Monies for DSM programs should be redirected to renewables.

For example, starting in 2000, TEP has shifted DSM funds from DSM programs to renewable energy resources. The decision established the funding level for TEP's EPS as follows:

Year	EPS Funding Level	DSM Funding Level
2000	$1,500,000	$1,600,000
2001	$1,600,000	$1,500,000
2002	$1,800,000	$1,300,000
2003	$2,000,000	$1,100,000
2004 – 2007	$2,250,000	$850,000

Q. Does UniSource believe that RUCO's proposal that the Citizens' properties be required to have $1,000,000 in DSM funding is comparable to funding levels of other Arizona utilities?

A. No. UniSource believes that the current DSM funding level for Citizens is appropriate based on a cost per customer analysis. The following chart develops a cost-per-customer comparison. It compares TEP's, APS' and Citizens' current programs, as well as the RUCO proposal by comparing the approximate level of current DSM funding to the number of customers.

	TEP	APS	Citizens - Current	Citizens-RUCO's Proposal
Current DSM Level	$1,300,000	$394,393	$175,000	$1,000,000
Customers	359,372	903,089	77,818	77,818
Cost per Customer	$3.62	$0.44	$2.25	$12.85

I would also note that TEP's DSM spending-per-customer would continue to decrease as the dollars allocated to EPS increases. In 2004, TEP estimates the cost per customer for DSM spending will be $2.27.

Q. Has the Commission addressed the issue of DSM in recent dockets?

A. Yes. DSM policy was discussed during the Track B workshops and hearing. Ultimately, the Commission found, "We will therefore direct Staff to facilitate a workshop process to explore the development of a DSM policy and an environmental risk management policy, with such exploration to include an examination of the possible costs and benefits of the respective policies, and to file a report, within 12 months from the date of this Decision, informing the Commission of the progress achieved in the workshops." (Decision No. 65743).

Q. What is UniSource's conclusion?

A. UniSource believes that Citizens' current level of DSM spending is appropriate. However, UniSource is willing to work with Staff, RUCO and other interested parties to review the design and allocation of DSM funding.

I also believe it is prudent and in the public interest for the Commission to conduct a comprehensive review examining the costs and benefits of DSM policy before requiring

UniSource to make a substantial funding increase, a cost that will ultimately be borne by customers.

Q. Does this conclude your testimony?

A. Yes.

TESTIMONY OF MICHAEL J. DECONCINI, JR.

UNISOURCE ENERGY CORPORATION

APRIL 28, 2003

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Michael J. DeConcini, Jr. My business address is One South Church, Tucson, Arizona, 85701.

Q. With whom are you employed?

A. I am Senior Vice President of Investments and Planning for UniSource Energy and Senior Vice President and Chief Operating Officer of Energy Resources for Tucson Electric Power Company ("TEP").

Q. What are your duties and responsibilities at TEP?

A. My areas of responsibility include fuels procurement and management, wholesale power trading and marketing, and power plant operations at TEP. I am also involved in UniSource affiliate investments and strategic direction related to planning and growth opportunities, including acquisitions such as the Citizens Arizona properties, the subject of this case. I have been with TEP/UniSource for 14 years and involved in the wholesale power areas in various positions for 11 of those years.

Q. What is your educational background?

A. I have a Bachelor of Science Degree in Finance from Moorhead State University and a Master of Business Administration Degree from Arizona State University.

Q. What is the purpose of your testimony?

A. My comments will address comments submitted by the City of Nogales regarding the efficacy of the contract between Citizens and Pinnacle West Capital Corporation effective June 1, 2001 and dated July 16, 2001 ("PWCC Contract"), as well as augment certain issues discussed in the Staff Report regarding the PWCC Contract.

Q. Please summarize your testimony.

A. In short, my testimony demonstrates that the PWCC Contract was prudent at the time it was entered into and provides a fixed price comparable to other alternatives to Citizens but with less operating and financial risk.

II. PRUDENCE OF PWCC CONTRACT

Q. Please describe the highlights of the PWCC Contract.

A. It is a full-requirements, firm power contract at a fixed price of $58.79/MWh for the term and includes transmission to Citizens receipt points on the WAPA transmission system. Citizens peak load in 2002 was approximately 320 MW with a load factor of 50% and annual growth rate of approximately 3%. The contract does not create stranded costs in a competitive environment as competitive power procured by customers is excluded from the supply agreement.

Q. Define the term "full requirements".

A. Full requirements means that the supplier will provide any and all power consumed by the purchasing entity on an instantaneous basis including future load growth. It provides instant access to the necessary capacity, energy and ancillary services required by the purchasing entity's retail customers and assumes all the operational and financial risks associated with meeting that demand.

Q. Please describe the components in the PWCC Contract that make up the full requirements?

A. *Firm Capacity and Energy* – PWCC must maintain sufficient available capacity to provide Citizens' requirements at all times, including during weather extremes. PWCC must further insure sufficient capacity is added to provide for Citizens' load growth.

Network Transmission charges – The PWCC Contract price includes the necessary network transmission service necessary to deliver power to Citizens' receipt points on WAPA's transmission system (Pinnacle Peak and Saguaro substations).

Transmission losses – Transmission losses on PWCC's system to Citizens' receipt points are also included in the fixed price.

Ancillary services – These services include such items as energy imbalance and regulation that are required to provide uninterrupted and instantaneous response to Citizens' changing demand.

Q. Given that the PWCC Contract contains all of these components, how do you value the contract?

A. To fully evaluate the current value of the PWCC Contract, one must first identify all of the components included in the PWCC Contract and then ensure that the market prices and alternatives include these components. As previously stated, the PWCC Contract includes firm capacity and energy, transmission, losses to Citizens' receipt points, and ancillary services necessary for load-following all of which have value/costs which must be determined.

Q. How do you determine such costs?

A. Firm energy and capacity are easy to determine for 100% load factor products by using forward price curve data that is readily available. However, taking into account the necessary components to provide load-following ability complicates matters. The only component of the price that is fairly easy to value is network transmission. The remaining value is best estimated by pricing a load-following resource-based alternative.

Q. What is the approximate value of the network transmission service embedded in the PWCC Contract?

A. It is approximately $3.35/MWh based on 2002 data from Pinnacle West's OATT Network Service Agreement with APS for serving Citizens.

Q. What were the forward prices for contracts similar to the PWCC Contract entered into during the period that PWCC and Citizens were negotiating?

A. There were numerous contracts entered into during this period, the majority of which were in California. California Energy Resource Scheduling, the California state entity which entered into long-term energy contracts on behalf of the load-serving utilities in 2001, has a list of its contracts posted on its website (http://wwwcers.water.ca.gov/contracts.html). Because California and Arizona had such directly connected markets during this period, these contracts provide a good indication of prices in Arizona and the rest of the Southwest. The table below shows a sample of such fixed price contracts that were entered into during the same 2001 period that Citizens and PWCC negotiated their agreement. (See the website referred to above for complete contract details).

Effective Date	Term	Product(s)	Current Price*
Mar 23, 2001	Mar 2001-Dec 2011	7x24	$61.00
Mar 2, 2001	Mar 2001-Dec 2004	On-Peak, 7x24	$119.50
Feb 9, 2001	Feb 2001-Dec 2005	On-Peak	$115/$127
May 24, 2001	May 2001-Jun 2012	On-Peak	$169

*Price per Megawatt-hour for current energy delivery as of April, 2003

From the Table above and with more detailed analysis of the contracts on the website, one can clearly see that the energy prices for long-term agreements entered into during the first half of 2001 were significantly higher than the price PWCC and Citizens agreed to in the Contract. It is also important to note that: 1) none of the above California contracts is a full-requirements contract like the PWCC Contract, as they are 100% capacity take or pay fixed delivery contracts, and 2) none of the above referenced contracts has been renegotiated.

Q. If you were to price a load-following resource-based alternative based on the forward market prices in April of 2001, what price range would you have thought appropriate?

A. UniSource looked at analyzing the price for a contract similar to the PWCC Contract in two ways. First, utilizing a resource-based alternative, and second, using a market-only alternative. The price range for these two options was approximately $60 to $80/MWh.

Q. Please describe the resource-based analysis.

A. TEP analyzed what a fully dispatchable combined cycle would cost Citizens to serve its load assuming immediate availability and full access to economic market purchases and sales using forward gas prices based on the same mid-May 2001 TEP forecast and standard plant operating assumptions. This analysis resulted in wholesale delivered price, including the network transmission costs to Citizens' receipt points, of approximately $60/MWh. The analysis was performed using TEP's ProMod production modeling program and the assumptions delineated in Exhibit 1.

Q. Why is the resource-based price so much lower than the contracts entered into in California?

A. The resource-based analysis included the assumption that the capacity (plant) would be immediately available which would not have been feasible at the time. Due to the necessary time to permit and build a new plant, the California contracts reflected market-based prices for the first 2 years which put upward pressure on the term contract prices.

Q. Please describe your market-based analysis.

A. Using forward prices as of mid-May 2001 from TEP's own historical forecast and Citizens hourly load shape and assuming that all of Citizens power would be procured from the market, the average price for firm energy and the network transmission costs to Citizens' receipt points would be approximately $80/MWh.

Q. How do these two options compare to the PWCC Contract with all of its components?

A. These alternatives place much more risk on Citizens and its retail customers as they require Citizens to manage the deliverability and availability of fuel and/or market power purchases, market price risk of gas and/or power, operational risks of resources and the risk of stranded costs associated with competitive direct access. Further, neither of these two options contain the costs associated with load-following ancillary services.

Q. What are the costs for load-following ancillary services?

A. These costs vary from a number of factors, including the control area in which the load is served, the amount of load variability, the amount of reserves that are self-provided and resource performance characteristics. Due to this variability, we ignored these costs in the analysis, but would estimate the costs to be a few to several dollars per MWh.

Q. Are these prices consistent with what TEP saw during this period?

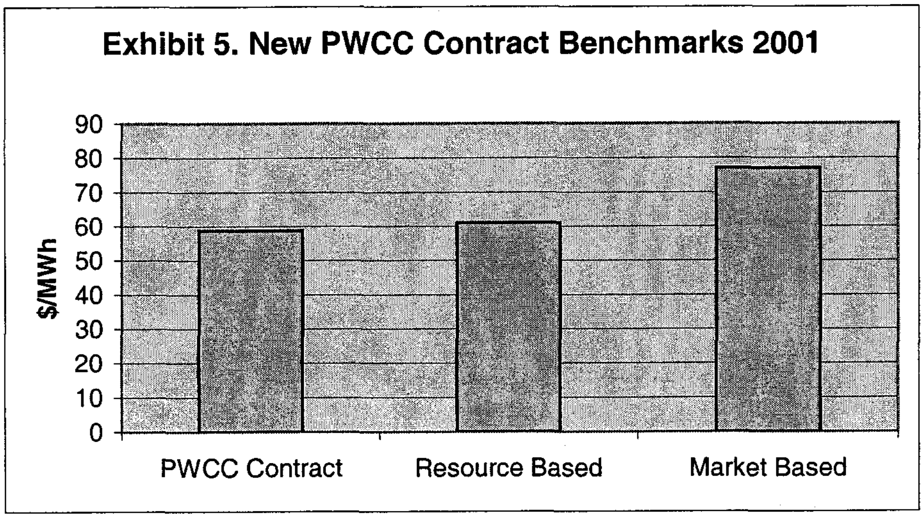
A. Yes. TEP was in the process of negotiating a 5 year sale at the time and had thoroughly evaluated the forward price curves.

Q. Did TEP feel that the forward price curve was an accurate reflection of expected future short-term prices?

A. Yes. TEP had no reason to believe otherwise. In fact, TEP purchased power gas and power for the summer of 2001 based on these forward curves.

Q. Do you feel that the PWCC Contract was a prudent purchase at the time?

A. In light of the information available to Citizens at the time of their negotiations with PWCC and TEP's own analysis and valuation of the market costs to supply Citizens' load on similar terms as the PWCC Contract, as well as the benchmarks provided by other wholesale agreements entered into during this period, I feel that the PWCC Contract was not only prudent but at a discount to other alternatives as demonstrated in Exhibit 5 below.



III. CURRENT VALUATION OF THE PWCC CONTRACT

Q. Are the current forward prices as quoted at the Palo Verde Hub a good benchmark for what Citizens should be paying for its power?

A. No. The current forward prices at Palo Verde represent a 100% capacity factor, take or pay energy price that has very little resemblance to the full-requirements, load-following, approximately 50% capacity factor nature of Citizens' load. In addition to these items, the demand of Citizens' retail customers is heavily weighted to hot summer months which generally produce the highest market power prices in the Southwestern U.S., including Arizona.

Q. What do you consider Citizens' likely alternative to the PWCC Contract for serving its load?

A. TEP has analyzed a resource-based alternative we believe would be the most likely and comparative alternative to a full-requirements contract like the PWCC Contract. The most obvious choice for a resource-based generation alternative to serve Citizens' load is a new

Combined-Cycle unit with sufficient capacity to cover Citizens' load. These new units have a heat rate in the range of 7,000 Btu/kW at 100% load and a capital installation cost in the range of $600 to $700/kW. TEP has estimated the current forward gas prices for the remainder of the PWCC Contract term at approximately $4.30/mmBtu for delivery at the Permian Basin. The delivered gas price includes transportation, fuel (losses), usage charges and taxes. Also included are transmission charges and losses.

Exhibit 2 details the all-in costs of gas and the expected all-in cost of providing a 50% capacity factor load like Citizens from a combined cycle plant. This all-in cost based on these assumptions alone amounts to $66/MWh. When the resource is utilized as part of a system that optimizes generation dispatch through market sales and purchases, it brings the total cost down to roughly $54/MWh. Both of these prices include network transmission to Citizens' receipt points. This was modeled using TEP's ProMod program in late March using assumptions listed in Exhibit 3.

Q. How does this option compare to the PWCC Contract?

A. A resource alternative has much more risk associated with it including deliverability and availability of fuel and/or market power purchases, market price risk of gas and/or power, operational risks of resources and the risk of stranded costs associated with competitive direct access. Further, the price does not contain the costs associated with all of the ancillary services necessary to compare directly to the PWCC Contract as previously discussed.

Q. Do you have any other data that validates your previous analysis of Citizens' contract alternatives?

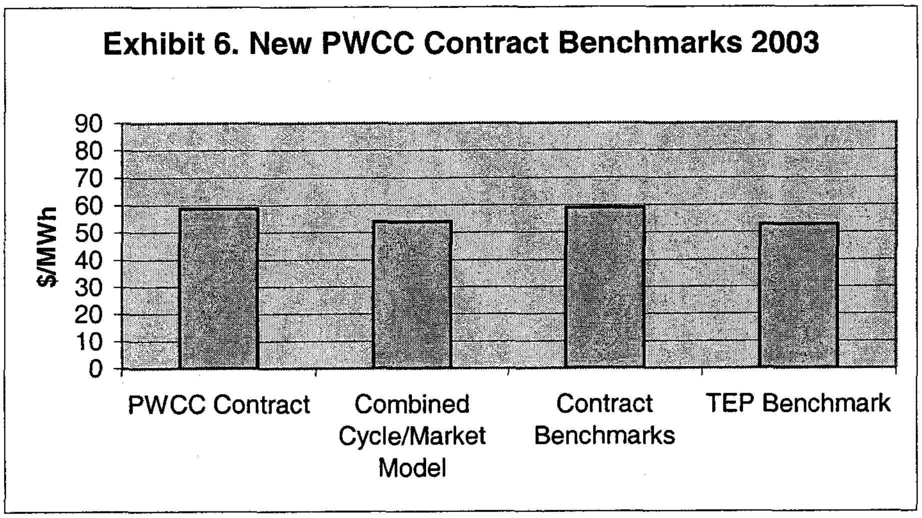
A. While it is difficult to get detailed information on third-party contracts, Exhibit 4 provides information on one such contract gleaned from data in an energy industry publication article.[1] While the contract is not a full-requirements contract, it does provide a relevant data point for evaluating forward prices for a somewhat shaped energy product. The price of this contract for 100 MW on peak and 50 MW off peak is $59/MWh.

TEP has also obtained current, competitive benchmarks that validate this analysis. TEP's Track B Competitive Solicitation bids received for supplying a portion of TEP's load provide the most current and directly comparable data available. While the specific details of most of these bids are confidential, the analysis shows that TEP's assumptions used in evaluating Citizens' options are indeed accurate. In fact, one such bid received without a confidentiality agreement in this solicitation was for a dispatchable Combined-Cycle plant for a term very close to that remaining on the PWCC Contract for delivery at Palo Verde with a $8.50 per kW per month capacity charge, an energy charge based on Daily San Juan gas price and a 8,000 btu/kWh heat rate, O&M charges of $3/MWh and additional startup charges which all closely align to TEP's assumptions in Exhibit 3. The Commission Staff and its independent monitor can confirm the congruence between TEP's assumptions and the other bids received as they have access to this confidential information.

Q. What is your view of the price of the PWCC Contract given this information?

[1] California Energy Markets, January 31, 2003, page 13.

A. As shown below in Exhibit 6, the PWCC Contract price is reasonable when compared to all the benchmarks reviewed by TEP. Further, the PWCC Contract leaves the majority of the operating and financial risks of the Citizens' supply with PWCC and provides more flexibility than any of these benchmarks.



IV. MISCELLANEOUS ISSUES/REBUTTALS

Q. How does the fact that the Settlement Agreement calls for UniSource to forfeit recovery of the PPFAC balance from customers, including the first 26 months of the PWCC Contract, affect the wholesale rate customers pay?

A. This Settlement Agreement and the forfeiture of customer recovery of the entire PPFAC balance, including the old PWCC agreement provides Citizens' customers with a wholesale energy rate equal to the current base rate of $0.04802 /kWh for the entire 2000/2001 period when prices in the wholesale market reached historically high levels of several times this rate. Due to the forfeiture of the first 26 months' (June 2001 through

July 2003) recovery of the PPFAC balance from the PWCC Contract, the effective rate seen by customers for that period was also the old base rate of $0.04802/kWh.

Q. The City of Nogales states in its opposition to the Settlement Agreement: "The allowance of 10% line losses in the wholesale power rate is unjustified as this level of line loss is for a distribution system, not a high voltage transmission system." Do you agree?

A. No, I believe the City of Nogales misunderstands the 10% line losses in the Settlement Agreement. The losses in the agreement include both the high voltage transmission losses on WAPA's transmission system (~4%) to get the power from the PWCC delivery points of Saguaro and Pinnacle Peak to substations to the high voltage side of Citizens' distribution system, ***plus*** the distribution losses (~6%). The sum of the transmission and distribution losses is approximately 10%. This number is also comparable to TEP's transmission and distribution combined losses of approximately 9.4%.

Q. It has been stated in others' testimony and/or comments during settlement proceedings that the PWCC Contract entered into by Citizens was during a period of "market manipulation." Is this relevant to this proceeding?

A. No. While FERC has stated in its March 26, 2003 Order in the California Refund case that there was apparent market manipulation during the time period that Citizens and PWCC entered into the agreement, FERC has not to date ruled that any contract entered into during this period should be abrogated. Further, both parties entered into the PWCC Contract with equal access to market prices, conditions and information and the contract is at the low end of prices for contracts signed during that timeframe. The existence or nonexistence of market manipulation in 2000/2001 is irrelevant as I have demonstrated in my testimony and the PWCC Contract is a fair value on a going-forward basis.

Q. Does this conclude your testimony?

A. Yes, it does.

Exhibit 1.

Assumptions for Evaluation of New WPCC Contract Based on 2001 Data

LOAD-FOLLOWING RESOURCE EVALUATION

- Immediate availability
- TEP's actual forward gas price curve data used in its forecasting and planning in mid-May 2001 for the 7 year period of the PWCC Contract. Details are confidential.
- TEP's actual hourly forward spot price curve data used in its forecasting and planning in mid-May 2001 for the 7 year period of the PWCC Contract. Details are confidential.
- Citizens hourly load forecast.
- $8 per kW per month demand charge
- $3.35/MWh for Network Transmission based on 2002 actual data.
- Excluded other ancillary service charges related to load following, regulation, etc.
- Economically dispatched plant to spot market allowing purchases when under incremental cost of plant and sales of excess plant capacity to market when above incremental cost.
- Result was approximately $60/MWh

Exhibit 2.

Combined Cycle Generator Costs and Assumptions

Combined Cycle Generator

Initial Capital Cost	$650	per kW installed
Installed Cost for 300 MW	$195,000,000	
Resulting Capacity or Demand Charge	$7.75	per kW per month, based on 60/40% debt/equity ratio, 7.75% debt & 11% ROE
Combined Cycle Heat Rate	8,000	Btu/kWh based on 50% Capacity Factor
Total Cost of Gas (see below)	$4.99	per MMBtu
Production Energy Charge	$39.90	per MWh (heat rate times cost of gas)
Variable O&M Cost	$2.00	per MWh
Transmission Charges	$3.35	Based on 2002 Actual Data
Total Energy Charge	$45.25	per MWh
Citizens Peak Demand	300	MW, approximately
Avg Citizens Monthly Energy Required	109,500	MWh at a 50% load factor
Cost of Demand per month	$2,325,000	Monthly Demand times Demand Charge
Cost of Energy per month	$4,954,509	Mothly Energy times Energy Charge
Total Cost per month	$7,279,509	
Total Cost per month per MWh	**$66.48**	

Gas Cost		
Permian Basin Price - 5/03 - 6/08	$4.27	Based on Forward prices as of April 4, 2003
Fuel (losses)	$0.14	Fuel Losses on El Paso Pipeline
Taxes @ 5.6%	$0.25	State Tax Rate
Usage	$0.03	Basin Usage Charge for Permian
Transportation	$0.30	El Paso Transportation Cost
Total Gas Costs	**$4.99**	

Exhibit 3.

Resource-Based Alternative to New APS Contract

Assumptions:

- TEP's actual forward gas price curve data used in its forecasting and planning in early April 2003 for the remaining period of the PWCC Contract. Details are confidential.
- TEP's actual hourly forward spot price curve data used in its forecasting and planning in early April 2003 for the remaining period of the PWCC Contract. Details are confidential.
- Citizens Hourly load forecast.
- $8 per kW per month demand charge and a 350 MW Combined Cycle with a minimum load of 100 MW.
- Immediate availability
- $3.35/MWh for Network Transmission based on 2002 actual data.
- Excluded other ancillary service charges related to load following, regulation, etc.
- Economically dispatched plant to spot market allowing purchases when under incremental cost of plant and sales of excess plant capacity to market when above incremental cost.
- Result was approximately $54/MWh.

Exhibit 4.
2003 Contract Comparison

Nevada Power Contract

Supplier	Entered January-03
Calpine Power	3 year term 100 MW on-pk, 50 MW off-pk
Cost/yr (millions)	$43
MW	100
MWhs	730,000
$/MWh	$59

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SUPPLEMENTAL TESTIMONY OF KEVIN LARSON

Q: What is the purpose of your supplemental testimony?

A. The purpose of my testimony is to address the questions raised by Commissioner Gleason in his letter to the parties dated April 24, 2003. The questions raised by Commissioner Gleason are repeated below in the same order as they appeared in his letter.

Q. What are the policy implications of a regulated utility loaning money to its parent company in exchange for an interest in a third company where the value of the security is questionable?

A. From a policy perspective, the Commission established AAC R14-2-801 et seq., Public Utility Holding Companies and Affiliated Interest, as a regulation to monitor, control and review transactions between affiliated companies. Certain affiliate transactions, including loans, must be reviewed and approved by the Commission. The Commission reviews the transaction to determine if the transaction would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service.

In the case of TEP, which is seeking authority to lend up to $50 million to its parent company to help fund the acquisition of utility properties from Citizens, I believe that a $50 million loan from TEP would not impair TEP's financial status, its ability to attract capital, or its ability to meet its public service obligation. Under the current rate freeze, TEP is anticipated to generate enough cash flow to fund a $50 million loan, meet its ongoing capital expenditure requirements and retire an average of $30 million to $50 million of debt and lease obligations each year. Due, in part, to TEP's strong cash flows, we expect the credit rating agencies to sustain the current credit rating of TEP even if a $50 million loan is provided. Further, to the extent that TEP's cost of capital were to increase as a result of the loan to UniSource, the Settlement has specific "hold harmless" language in it that would prevent TEP from passing along such a cost increase to its customers.

Q. How do customers benefit from a TEP loan to UniSource? What risks are involved?

A. As specified in the Settlement, a portion of the interest received by TEP on the loan will be recorded as a deferred credit and used to reduce the future rates charged to TEP retail customers. Additionally, TEP will earn a higher rate of return on the loan amount relative to current money market rates. This incremental interest income will serve to increase TEP's earnings and common equity balance. The financial flexibility that such a loan would provide UniSource in funding the acquisition should also be considered. To the extent that economies of scale are ultimately realized by UniSource and TEP as a result of the acquisition, flexibility in financing the acquisition should be viewed as a means of obtaining long-term cost savings for TEP and its customers.

Risks associated with such a loan would be minimal because the cash resources of UniSource are expected to be more than sufficient to pay the estimated annual interest payments of only $3.25 million per year on a $50 million loan balance. By the end of the four-year loan term, UniSource would repay the loan by using cash on hand or by raising new funds in the debt or equity markets. In light of the financial progress made by TEP, the largest subsidiary of UniSource, and the solid financial footing being planned for the new UniSource subsidiaries ("New Companies") that will own and operate the Citizens assets, the prospects for loan repayment are very high. In the unlikely event that UniSource would be unable to meet the loan repayment obligation, ownership of the New Companies would transfer from UniSource to TEP per the terms of the Settlement Agreement. Since the total equity investment by UniSource in the New Companies is expected to be approximately $90 million, the value of these ownership interests should be well in excess of the loan amount from TEP.

Q. How will TEP's $50 million loan to UniSource affect TEP's liquidity? Will TEP have to borrow the money in order to lend it to UniSource? If so, is the loan inconsistent with the policy found in FERC's February 21, 2003 Order in Docket No. ES02-51-00 relating to the issuance of debt by a regulated utility for non-utility purposes? If TEP does not have to borrow money to loan $50 million to UniSource, how will the reduction of TEP's cash-on-hand affect its financial health?

A. As described above, TEP's net cash flow is expected to be sufficient to meet planned capital spending needs and our stated objectives for debt and lease retirements. Additionally, TEP has a $60 million revolving credit facility to help it meet short-term liquidity needs. Since TEP's cash flows are highly seasonal, the ability to fund a $50 million loan to UniSource with cash on hand is dependent on when the acquisition is closed. Current projections of TEP cash flows for 2003 reflect an anticipated cash balance of $42 million by the end of July, growing to over $100 million by the end of October. If the acquisition occurs in July or early August, TEP may have to borrow from its revolving credit facility to fund a portion of any loan to UniSource. However, any such borrowing under TEP's revolving credit facility would be repaid in full within a short period of time.

Regarding the above referenced FERC order, there are many differences between that case and the circumstances in this proceeding. The most significant difference is that TEP would not be issuing new long-term debt to fund any loan to UniSource. Additionally, any loan proceeds would be used by UniSource to acquire *regulated* assets within the same state regulatory jurisdiction, and would not be used to fund *unregulated* parent company investments. For these reasons, as well as others, the authority sought by TEP in this proceeding is not in conflict with the principles established by the FERC.

Q. Could TEP guarantee a $50 million loan by UniSource? What benefits does a guarantee provide?

A. If the Commission granted authority for a TEP guarantee, UniSource could attempt to obtain outside financing on the basis of the guarantee. However, such a transaction would involve additional time and expense to UniSource, and would add to the overall debt leverage of the consolidated entity. The guarantee would also be taken into account by credit rating agencies and potential lenders in assessing the creditworthiness of TEP.

Q. Since the purchase price is $230 million and the Settlement allows the New Companies to borrow up to $475 million and UniSource is providing $75 million to $125 million in equity, why couldn't UniSource acquire Citizens Gas and Electric Divisions without TEP's financial assistance?

A. The levels of debt that the New Companies will be allowed to borrow to fund the acquisition, shown on Appendix A to the Settlement are not additive. The funding alternatives requested in Appendix A are to provide UniSource with flexibility and assurance that we can fund the transaction on the acquisition date. For example, the bridge financing provides us an alternative if a more permanent form of capital is unavailable, too expensive, or inappropriate at closing. In total, assuming a purchase price of $230 million, we expect to fund approximately $140 million of the acquisition with longer term debt at the operating company level and approximately $90 million with an equity investment from UniSource. Additionally, up to a $50 million revolving credit facility is intended to support the short-term liquidity needs of the New Companies and is not intended to fund the initial purchase price.

The source of the approximate $90 million equity investment could come from cash on hand at UniSource, from cash borrowed from TEP, or from an external financing at UniSource. Although UniSource currently has a shelf registration pending with the SEC that would allow UniSource to issue up to four million shares of common stock, there is no guarantee that stock market conditions will be conducive to such an offering. As such, the ability of UniSource to borrow money from TEP provides additional flexibility in funding the acquisition in a timely and cost effective manner.

Q. Does the current restriction on dividend receipts sufficiently encourage a parent company to increase the equity ratio of its subsidiaries? Specifically, since TEP is below 37.5% equity, what incentive is there to increase its ratio unless that effort brings it above the

37.5% benchmark? Alternatively, since UniSource receives dividends on 75% of the earnings if TEP's equity ratio is 35%, 25% or even 15%, what incentive does UniSource have to prevent TEP's equity ratio from falling?

A. The cost and availability of debt capital is a function of perceived creditworthiness. Since a company's net worth is typically used as an important measure of creditworthiness, TEP's equity ratio has a significant effect on its credit ratings and cost of debt capital. As a subsidiary of a publicly traded company, the management of TEP has a fiduciary duty to shareholders to reduce costs and improve profitability. This fiduciary duty acts as a strong incentive to increase TEP's equity ratio and reduce its cost of borrowing over time. Additionally, TEP is required to abide by certain financial covenants contained in its loan agreements. Compliance with these covenants would not permit TEP to lower its equity ratio through large new borrowings or through dividend payments in excess of annual earnings.

Q. Has TEP made progress on improving its balance sheet and equity ratio?

A. Yes, TEP has made significant improvement. As shown on the attached Exhibit 1, from December 1998 to December 2002, TEP's equity improved from $230 million to $337 million and its equity ratio increased from 16% to 23%.

Q. Should the Commission consider implementing a graduated dividend structure to encourage a parent to increase the subsidiary's equity ratio? For example, if a subsidiary's equity ratio fell below 25%, the parent company would receive dividends from 60% of the earnings. If the ratio fell below 15%, the parent would receive dividends from 30% of the earnings. Would such a graduated structure provide an incentive to maintain as high an equity ratio as possible?

A. As with other corporations, decisions regarding dividend policy appropriately fall within the purview of the regulated company's Board of Directors. The restrictions on TEP dividends contained in prior Commission orders, as well as the proposed Settlement, were the result of voluntary negotiations between TEP's management and other parties to Commission proceedings. As stated previously, UniSource has a natural incentive to preserve its financial well-being and to reduce its cost of capital through its fiduciary duty to shareholders to reduce cost and improve profitability. UniSource believes it would be inappropriate to require additional external "incentives" on dividend policy.

Q. Generally, does a higher equity ratio produce a financially healthier utility which, in turn, allows it to have increased operating funds, incur loans at a lower interest rate and to be better prepared for any unexpected occurrences in the market thus protecting the rate payers?

A. Generally speaking, yes. However, it should be noted that equity capital is the most expensive source of capital. For that reason, most corporations attempt to finance themselves with a reasonable mix of debt and equity capital. Given the cost advantage of debt capital, the impact on a utility's cost of service should be considered in any evaluation of capital structure.

A. Does this conclude your supplemental testimony?

A. Yes.

Tucson Electric Power

	12/31/1998	12/31/1999	12/31/2000	12/31/2001	12/31/2002
Equity	230	270	296	322	337
Debt	1,186	1,185	1,134	1,132	1,130
Total	1,416	1,455	1,430	1,454	1,467
Equity	16%	19%	21%	22%	23%
Debt	84%	81%	79%	78%	77%
Total	100%	100%	100%	100%	100%

Exhibit 1 - Larson Supplemental Testimony