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BEFORE THE ARIZONA CORPORATION COMMISSION

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 NOs. G-01032A-02-0914 E-01032C-02-0914 E-01933A-02-0914 CITY OF NOGALES POST HEARING BRIEF E-01032C-00-0751 G-01032A-02-0598 E-01933A-02-0914 E-01032C-02-0914 G-01032A-02-0914

Intervenor City of Nogales submits the attached Post Hearing Brief

RESPECTFULLY SUBMITTED this 14th day of May, 2003.

Arizona Corporation Commission
DOCKETED
MAY 15 2003
DOCKETED BY

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Hugh Holub, Attorney
City of Nogales, Arizona

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By_____
Jan Burks

POST HEARING BRIEF
SUBMITTED BY THE CITY OF NOGALES, ARIZONA

I. INTRODUCTION:

The Arizona Corporation Commission (ACC) is being asked to approve the transfer of Certificates of Convenience and Necessity (CC&N) from Citizens Communications Company to a subsidiary of UniSource (the Applicants) for electric and natural gas service in, among other places, Nogales, Arizona and Santa Cruz County.

The CC&N transfer application has been merged with applications for a natural gas service rate increase, and approval of a purchased power adjustment.

ACC Staff has entered into a Settlement Agreement with Citizens and UniSource, and a hearing regarding the Settlement Agreement was recently held.

After initial discussion involving all parties to these proceedings, ACC Staff chose to negotiate unilaterally with Citizens and UniSource, allowing other parties to conduct their own separate negotiations with the Applicants. These separate negotiations were fruitless, and it was clear that the Applicants were determined to accomplish their goals based solely on Staff's negotiating abilities. The result is a proposed Settlement Agreement that is not acceptable to Nogales. The issues of concern to Nogales have simply not been resolved via the Settlement Agreement.

It is the mandate of the ACC to look out for the interests of the consumer. State v. Tucson Gas & Electric, 15 Ariz.294 at 308 (1915). The proposed Settlement Agreement does not do so.

II. UNISOURCE IS DICTATING TO THE ACC VIA A "PACKAGE DEAL":

It is abundantly clear from the Application and the Settlement Agreement that UniSource and Citizens have created a tightly wrapped Package Deal that they refuse to modify in any meaningful way. The Settlement Agreement does nothing to change the basic structure of the Package Deal.

As noted by UniSource CEO James Pignatelli in cross-examination:

> "This is one transaction to UniSource who must conclude this transaction as one package. UniSource has the option to walk from this transaction, and we will...."
>
> "If this settlement is not adopted, UniSource will walk..." Hearing Transcript Page 74.

Pignatelli made it even clearer a few minutes later:

"Q....I just want to make sure I understand that you do feel this is a bargain basement type of price for these types of assets, is that correct?

"A. [Pignatelli] That's correct.

"Q. And in fact, it's far below what the book value would probably be for the assets?

"A. That's correct."

"Q. Now, you've also testified this morning I'd say in no uncertain terms that you are quite willing to walk away from this entire deal if you feel that the Settlement Agreement isn't acceptable in its present form?

"A. That's correct.

"Q. Is there any room at all in your mind for tweaking, you might say, this agreement, or is there no room for movement at all as far as UniSource-TEP is concerned.

"A. [Pignatelli] You know, it's very interesting. I believe this is a very fair settlement balance. If you say would I take one dollar less in revenue, that's a tweak, perhaps. If you say $10 less, perhaps. But that's still violating a very fair balance, and at some point in time, I would have to take into consideration whether I want to serve a group that would continuously nickel and dime and try to get something out of the shareholder's pocket." Hearing Transcript Pages 88-89.

III. THE CLAIMED "BENEFIT" OF AVOIDED LIABILITY FOR CITIZENS' PURCHASED POWER COSTS IS A SHAM:

One of the primary justifications for the Package Deal and "benefit" to ratepayers is the avoidance of an estimated $135 million in purchased power costs incurred by Citizens.

However, this liability has never been determined to be recoverable from ratepayers.

More importantly, is the reality that, given Citizens' desire to sell its Arizona electric and natural gas systems, the purchased power liability would likely NEVER be passed onto ratepayers. As noted by Dennis McCarthy, Citizens witness:

"A. I think, when you look at the property as it sits today, probably one of the biggest problems is that $120 million deferred bank balance. It had nothing really to do with the purchased power agreement that's there right now. At least that's been the feedback that I've gotten."Hearing Transcript Page 470.

Thus, the claim that ratepayers would have faced some portion of the "deferred bank balance" is

mere speculation. It is just as probable that no buyer in their right mind would assume that liability and attempt to recover it given the record of the PPFAC case to date, and the growing realization that Western energy markets were manipulated in that subject period.

The claim that consumers are somehow benefitting from the Package Deal is nothing more than public relations perfume to make the Package Deal smell good. An unsubstantiated claim, in the face of the jurisdiction of the ACC to approve or disapprove of all of the excess purchased power costs, and the potential for any sale to exclude this liability, renders the claim as insubstantial for legal purposes to justify the approval of the Settlement Agreement.

IV. THE CLAIM OF RATE BASE REDUCTION IS ANOTHER PUBLIC RELATIONS EFFORT:

A major benefit of the proposed acquisition by UniSource is the reduction in rate base for electric assets.
In effect, the ACC is determining the rate base in the case. This is problematic in light of Scates v. Arizona Corporation Commission, 118 Ariz 531, 578 {2d 612 (1978) which requires a determination of a fair value rate base before rates can be increased.

In this case the ACC is not deciding what, of any of the assets of Citizens involved in the transaction, are "used and useful" and what their fair value is.

Just because a utility has a book value number does not bind the ACC to that number for fair value determination.

So, UniSource is buying the Citizens' assets for below book value. Obviously, as noted in Exhibit "A" attached, UniSource has no compunction in trying to recover the book value difference in a sale to a third party, otherwise why ask $35 million for a property bought for $19.4 million?

The ACC should be very careful in assuming the purchase price has anything to do with future rate base. What if UniSource turns around and sells the natural gas system in Northern Arizona for a price greater than what it paid for the system to Citizens? Is the Commission bound by the price UniSource paid, by the price a new buyer pays? Certainly the buyer, if subject to Commission jurisdiction, will want to recover the difference between the UniSource purchase price and a subsequent purchase price.

It should be remembered that Citizens was adamant in selling its Arizona properties as a single package, opening up the door to someone who could buy the package, then resell pieces of it at a profit to buyers interested in specific territories.

What if UniSource subsequently sells off the Mohave electric division to APS?

By focusing on the alleged rate base reduction benefit, and not asking the question "who gets the

benefit of a resale of the assets at a higher price?" the Commission is leaving itself exposed to some serious manipulation by UniSource.

Obviously UniSource will argue that any profit they can make from a resale of the assets will go solely to their shareholders.

"Q. Did you, you've talked about purchasing this thing as a bargain basement deal, correct?

"A. [Pignatelli] That's correct, and it does not approach the value I place in it.

"Q. Okay. So if you turn around and want to sell it to a city or county after you close, are you going to keep that same bargain basement price or what?"

"MR. CAMPBELL: Your honor, I am going to object to this line of questioning. Mr. Holub's client is engaged in eminent domain discussions with --

"ACALJ NODES: Objection sustained." Hearing Transcript Page 96

It was noteworthy that I was not even allowed to respond to the Objection before the line of questioning was cut off. And thus, Exhibit "A", which shows the value UniSource places on the Santa Cruz assets, could not be entered into evidence.

If the Commission does not address the issue of who gets the benefit of any resale of parts of the Package Deal, a massive gift will result to the shareholders of UniSource.

It is not the Constitutional mandate of the Commission to go making gifts to shareholders just to get rid of Citizens Communication in Arizona.

V. THE PROVISION ALLOWING UNISOURCE TO KEEP 40% OF ANY SAVINGS REALIZED FROM A RE-NEGOTIATED POWER PURCHASE AGREEMENT IS A GIFT TO UNISOURCE SHAREHOLDERS:

The Settlement Agreement proposes allowing UniSource to keep 40% of any savings realized from a renegotiation of the wholesale power purchase agreement with Pinnacle West. This is outrageous, and nothing less than a gift to the shareholders of UniSource.

The timing of the second Pinnacle West power purchase agreement (2001) and the unwillingness of Citizens to pursue claims of over-charging against Pinnacle West on the first contract is suspicious, to say the least.

The Applicants attempted to justify the second power purchase agreement as being reasonable at the time, disregarding many tough issues that Staff simply avoided. Yet, at the same time Staff

and Applicants were singing the praises of the second agreement, efforts were made to justify the "incentive" of allowing UniSource to keep a portion of any renegotiated contract reduction in cost.

The entire rate increase for electric service is based on this second wholesale power purchase contract.

Had the contract been renegotiated prior to the final decision of the ACC, the rate increase request would obviously be reduced. It could be zero.

In the Residential Utility Consumer Office's (RUCO) Direct Testimony, Marylee Diaz Cortez noted that:

> "A. Assuming a 40/60 sharing, as provided for in the agreement, and a negotiated 10% reduction in the contract price, UniSource would realize additional profits of $3 million a year. This truly represents a windfall considering that absent a 40/60 agreement, ratepayers would be entitled to 100% of any power cost savings." RUCO Exhibit 1, at page 10.

Lets put the $3 million a year (for 5 remaining years of the contract) in some context:

The total purchase price of Citizens' electric assets is approximately $93 million for approximately 75,000 customers, of which 16,000 are in Santa Cruz County. Divide $93 million by 75,000 and one gets a per customer purchase price of $1,240 each. Times the number of customers in Santa Cruz County, and the per customer price is approximately $19.4 million. Five years of pocketing $3 million a year yields $15 million. Thus, the ratepayers of Santa Cruz County are in effect being obligated to pay $15 million of the $19.4 million purchase price for the system.[1] Conceivably, the UniSource customers will end up paying 100% of the purchase price for the Santa Cruz electric system, depending on the results of confidential negotiations between UniSource and Pinnacle West that were noted during the hearing.

The ACC should not approve the rate increase requested by UniSource until after the contract is renegotiated, and pass on 100% of the reduction to ratepayers.

VI. UNISOURCE AND PINNACLE WEST HAVE ALL THE INCENTIVES THEY NEED FOR A RENEGOTIATED POWER PURCHASE CONTRACT:

The argument made by UniSource and Staff for 40% of the potential power contract savings being kept by UniSource is to create an incentive to renegotiate the contract. However, incentives

---

[1]Please note the letter dated February 7, 2003 from Pignatelli to Nogales Mayor Marco Lopez attached as Exhibit "A" in which Pignatelli offers to sell the electric system for $35 million plus $12 million for the Valencia Power Plant; and the City response dated March 11, 2003.

already exist.

By opening the market to retail competition, assuming the ACC can do so without allowing the utilities to sabotage the process with excessive wheeling and other charges, customers will be able to by-pass the Pinnacle West contract. Customers can also install distributive generation to avoid the rate increase.

The Settlement Agreement provides that "UniSource further agrees to not oppose municipal aggregation in principle as part of any plan to make resale access more likely within ElecCo's service territories."

Mr. Pignatelli noted that:

> "A. That consistent with the Commission's direction in open access that there is opportunity for aggregation of customers, and we would not oppose that.
>
> "Q. And just since, you know, you have a bunch of people here who are from cities and counties, explain a little bit what you understand aggregation to be?
>
> "A. It's when one entity takes and, takes the load of multiple customers and buys the power based on that multiple customer group.
>
> "Q. In other words, if the city or the county wanted to aggregate all of the customers in the county and buy our power directly at a rate other than your APS rate, we could do that?
>
> "A. That's correct." Hearing Transcript Page 97.

And on distributive generation the following exchange with Mr. Pignatelli resulted:

"Q,. In other words, large customers can put their own generation in and not purchase the wholesale power from you?

"A. If they can do it cost effectively, we have no issue with that. We would expect backup service, et cetera." Hearing Transcript Page 98

ACC Staff addressed the issue as well. Staff witness Lee Smith:

> "A. (Smith) There has been almost no competition in the Tucson and APS territory. The major difficulty is that customers' credits were very low. Customers had to beat a price of 3 and a half to 4 cents in those territories.
>
> "In this territory someone will only have to beat a price of 5.8 cents. That's where I see

the benefit.

"It's kind of like insurance. We've had discussion about whether this new contract is good or not good. Maybe we're wrong or maybe market prices, maybe the price of gas goes back to $2, nobody expects, market prices drop. In that case, every customer has the ability to find an alternative supplier and go and buy cheaper power with no stranded costs.

"Q. Why wait for 2004 for implementing this?

"A. There's no reason to wait to implement. It will simply take a certain amount of time. The company is going to have to unbundle her rates. They've been through this exercise once before, so it may not be very time consuming, but some things have changed' for instance, transmission rates have changed. To unbundle rates to allow customer choice, we have to tell them what they have to pay for transmission, what they get excluded for generation, that's quite easy, and what they pay for other costs....

"Q. Would the ability for, say, the largest customers in Santa Cruz County to take advantage of this in effect tell APS that their rate is too high and they're going to lose sales to some competitor?

"A. Yes.

"Q. So this is one element of an incentive for APS to renegotiate the contract?

"A. Yes, definitely." Hearing Transcript Page 346-347.

When Ms. Smith was asked about the role distributive generation might play in avoiding the high APS/Pinnacle West wholesale charges...

"Q. Would that be an incentive for APS to renegotiate the contract?

"A. Yes, both of those things will put pressure on APS. They know they have a real possibility of losing load." Hearing Transcript Page 348

Then:

"Q. But you have a proposal here that allows 40 percent of whatever savings occurs to remain with UniSource?

"A. (By Ms. Smith) Yes.

"Q. Why 40 percent? Why not 10 percent as recommended by RUCO, when there are

market pressures here that will break this contract nevertheless?

"A. I think Ms. Jaress already answered that, if she wants to discuss it further.

"It's just a part of total negotiations. The company has given up a potential collection of $135 million. They reduced rate by half. This was one of the things they wanted in return....

...

"Q. But it we were to support the 90/10 split that RUCO has suggested, would you agree to that or would you oppose us on that?

A. (By Ms. Jaress) Staff is committed to the terms of the agreement, so we would oppose that." Hearing Transcript Page 349

So....while UniSource doesn't oppose aggregation in principal, and ACC Staff expert Smith notes that the higher rate on the wholesale power contract is a positive for aggregation, 40% of the savings is still in UniSource's pocket because it is a Package Deal.

Since the "evidence" of this case consists mostly of speculation, how about an alternative speculation:

The ACC approves the Settlement Agreement with the 40% share to UniSource, and a few weeks later UniSource announces a new contract with Pinnacle West (which is probably already in final stages now) reducing the rates somewhat, but pocketing $3 million a year, and the UniSource ElecCo service areas are essentially immune from retail competition because the wholesale cost of power drops to the same levels (3.5 to 4 cents per KwH) as in Tucson and Phoenix.

Should anyone wonder why UniSource is so adamant about the rate increase coupled with the windfall potential from a new contract?

If our speculation is correct, UniSource will essentially obtain the Santa Cruz electric system for free--paid for from their 40% share of the savings of the rate increase.

Mr. Pignatelli comes across as a very smart utility executive. And very determined to have his way or he'll walk.

We ask the Commission to:

(A) Deny the purchased power pass-through requested by UniSource and require a new contract before any rate adjustment is authorized.

OR IN THE ALTERNATIVE:

(B) Eliminate the 40% windfall to UniSource from a renegotiated power purchase agreement and give 100% of any saving to customers;

(C) Move the date at which the electric service areas are opened to retail competition to December 31, 2003 to provide the necessary incentives to UniSource and Pinnacle West.

VII. THE FRANCHISE ISSUE:

There is no question but that Citizens does not have a franchise from the City of Nogales. And Mr. McCarthy's excuses for not negotiating one in the wake of the failure of the CAPROCK sale are lame. The fact is Citizens probably could not win a franchise election in Santa Cruz County given what we've been through...resulting in a City complaint against them, and a class action lawsuit Citizens settled for over $5 million.

The relevant law is as follows: Arizona Revised Statutes

> **40-283. Transmission lines; use of public streets for utility right-of-way; notice; election**
>
> A. Any person engaged in transportation or transmission business within the state may construct and operate lines connecting any points within the state and connect at the state boundary with like lines, except that within the confines of municipal corporations the use and occupancy of streets shall be under rights acquired by franchises according to law or licenses pursuant to title 9, chapter 5, articles 1.1 and 4, and subject to control and regulation by the municipal authorities. The use of highways, except state highways, by public utilities not within any incorporated city or town shall be regulated by the board of supervisors of the county by license or franchise.
>
> B. A board of supervisors in granting a license or franchise, or at any time after it is granted, may impose restrictions and limitations upon the use of the public roads as it deems best for the public safety or welfare.
>
> C. Every franchise granted under this article shall include provisions requiring the grantee to bear all expenses, including damage and compensation for any alteration of the direction, surface, grade or alignment of a county road, made for the purpose of such franchise. If the surface of a county highway is used by any grantee for trackage, the franchise shall include reasonable regulations for maintenance by the grantee of that portion of the highway so used.
>
> D. A board of supervisors may authorize public service corporations, telecommunications corporations or cable television systems to construct a line, plant, service or system within the right-of-way of any road, highway or easement that is designated for access or public

use by plat or survey of record of a subdivision, or of unsubdivided land as defined in section 32-2101, provided that any such authorization or construction pursuant to such authorization does not impose on the county the duty of maintaining the road or highway unless the county accepts the road or highway into the county maintenance system by appropriate resolution. Nothing contained in this subsection shall be construed to grant county boards of supervisors additional authority to require public service corporations, telecommunications corporations or cable television systems to obtain licenses or franchises.

E. A board of supervisors, before granting any of the privileges authorized under this section, shall give public notice of its intention to make such grant by publishing notice in a newspaper of general circulation, published within the county, at least once a week for three weeks prior to the day set for consideration of such action. If, on or before such date, more than fifty per cent of the qualified electors of the county petition the board of supervisors to deny such privilege, it shall do so, and any privilege granted against such petition shall be void.

The municipal provisions are as follows:

9-501. Grant of franchise

A. A municipal corporation shall not grant a franchise for a public utility to be operated by the grantee unless authorized by a majority vote of the qualified voters of the municipal corporation at a regular election or at a special election duly and regularly called by the governing body of the municipal corporation for that purpose.

9-502. Petition for franchise; publication; election; term

A. A person desiring to obtain a franchise to operate a public utility from a municipal corporation shall present the franchise desired to the governing body of the municipal corporation and it shall be filed among its records.

B. If the governing body deems the granting of the franchise beneficial to the municipal corporation, it shall pass a resolution, to be spread upon its record, stating that fact, and shall submit the question to the qualified electors as to whether or not the franchise shall be granted at the following regular election held in the municipal corporation or at a special election called for that purpose.

C. The proposed franchise shall be published in full in some newspaper of general circulation published in the municipal corporation for at least thirty consecutive days prior to the election.

D. If a majority of the votes cast is in favor of granting the franchise, the governing body shall grant the franchise only in the form filed and published.

E. A franchise shall not be granted for a longer term than twenty-five years.

F. An election held pursuant to this section shall be held on a date prescribed by section 16-204.

The relevant ACC provisions are as follows:

40-282. Application for certificate; hearing; application upon contemplated franchise

A. If the applicant for a certificate of convenience and necessity is a corporation, a certified copy of its articles of incorporation shall be filed in the office of the commission before any certificate of convenience and necessity may issue.

B. Every applicant for a certificate shall submit to the commission evidence required by the commission to show that the applicant has received the required consent, franchise or permit of the proper county, city and county, municipal or other public authority. [Emphasis Added]

C. The commission may, after a hearing, issue the certificate or refuse to issue it, or issue it for the construction of only a portion of the contemplated street railroad, line, plant or system, or extension thereof, or for the partial exercise only of the right or privilege, and may attach to the exercise of rights granted by the certificate terms and conditions it deems that the public convenience and necessity require. The commission may act after an application or after a hearing, if requested by any party, on an application for a certificate to provide any of the following telecommunications services:

D. If a public service corporation desires to exercise a right or privilege under a franchise or permit which it contemplates securing, but which has not yet been granted to it, the corporation may apply to the commission for an order preliminary to the issue of the certificate. The commission may make an order declaring that it will thereafter, upon application, under rules it prescribes, issue the desired certificate, upon terms and conditions it designates, after the corporation has obtained the contemplated franchise or permit or may make an order issuing a certificate on the condition that the contemplated franchise or permit is obtained and on other terms and conditions it designates. If the commission makes an order preliminary to the issuance of the certificate, upon presentation to the commission of evidence that the franchise or permit has been secured by the corporation, the commission shall issue the certificate. [Emphasis Added]

In the proposed Settlement Agreement UniSource is given 365 days to provide proof of a franchise to the ACC.

Under the law, the ACC may:

(1) grant an "order preliminary" to issue the certificate of convenience and necessity to UniSource for service inside Nogales, Arizona; or

(2) may make an order issuing a certificate on the condition that the contemplated franchise or permit is obtained and on other terms and conditions it designates.

The Settlement Agreement is defective in that it provides nothing in the event UniSource fails to obtain a franchise from the City of Nogales.

We made the franchise issue clear in the initial discussions with Staff when all parties were included. But Staff failed to understand the importance of the franchise question in light of the failure of Citizens to resolve the matter for years.

We ask the Commission to insert an additional provision mandating an order to show cause why the CC&N should not be revoked in the event UniSource fails to produce a franchise from Nogales, or any other jurisdiction in the service areas, within the proposed 365 day period.

VIII. CONCLUSION:

The ACC has been presented with a very pretty Package Deal that is wrapped very tightly for the benefit of UniSource and especially its shareholders.

The wrapping consists of sham claimed benefits of avoidance of purchased power expenses of Citizens that are not now, and may never be, the obligation of the ratepayers.

The bow tying this all together is the current Pinnacle West power purchase agreement with a 40% "windfall" to UniSource.

Inside this Package Deal is a skunk as far as the people of Nogales are concerned.

We get the highest electric rates in the state and see our economic development efforts destroyed.

For what? So we can replace one electric monopoly with another one regulated by an ACC?

The Arizona Corporation Commission has an opportunity to takes its Constitutional mandate seriously. The Commission must not accept the Package Deal as created by UniSource, and the Commission must act to protect consumers. The Commission can protect the consumers by:

(A) Denying the purchased power pass-through requested by UniSource and require a new contract before any rate adjustment is authorized.

OR IN THE ALTERNATIVE:

(B) Eliminate the 40% windfall to UniSource from a renegotiated power purchase agreement and give 100% of any saving to customers;

(C) Move the date at which the electric service areas are opened to retail competition to December 31, 2003 to provide the necessary incentives to UniSource and Pinnacle West;

AND:

Insert an additional provision mandating an order to show cause why the CC&N should not be revoked in the event Unisource fails to produce a franchise from Nogales, or any other jurisdiction in the service areas, within the proposed 365 day period.

Respectfully Submitted this 14th day of May, 2003

By _____
Jose Machado, City Attorney
Hugh Holub, Attorney
For: Intervenor City of Nogales, Arizona

EXHIBIT A

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February 7, 2003

Mayor Marco A.Lopez, Jr.
City of Nogales
777 N. Grand Avenue
Nogales, AZ 85621

Dear Mayor Lopez:

Based on your request, UniSource developed two proposals that I believe will allow us to move forward. These proposals are conditionally based on the transfer of ownership from Citizens to UniSource.

I. Franchise Fee Proposal: UniSource will agree to a 25 year franchise agreement with a two-percent (2%) franchise fee which will be shown as a separate line item on the customer's bill. The franchise agreement will be subject to a public vote from the citizens of Nogales, and will be paid for by UniSource.

II. Asset Purchase Proposal: UniSource will agree to sell to the City of Nogales the electric plant assets within the city limits, at their depreciated book value:

1) Purchase price for the electric transmission and distribution assets - $35 million. (Allocation based on number of customers.)

2) Purchase price for the electric generation assets - $12 million.

3) The City of Nogales shall be responsible for securing bonds in the amount of $16 million for capital requirements related to the 345 kV transmission line project as required by the Arizona Corporation Commission in Decision No. 62011,

or

The City of Nogales shall be responsible for the annual payment of $1.5 million or $16 million present value (40-year contract) for transmission service under Tucson Electric Power's Open Access Transmission Tariff (OATT).

4) In addition, UniSource has identified certain system upgrades which are necessary. The City of Nogales shall be responsible for its proportionate share of the required cost of such upgrades to the Santa Cruz Electric Division transmission and distribution system that occur prior to closing.

5) UniSource will sign a three-year operating agreement with the City of Nogales to operate and maintain the electric transmission and distribution system for the amount of UniSource's actual costs plus 20%. The operating agreement will include the following services:

   (a) maintenance
   (b) billing
   (c) meter reading
   (d) meter maintenance
   (e) customer service
   (f) call center
   (g) control area operations
   (h) engineering
   (i) planning

6) The City of Nogales shall be responsible for its proportionate share of the Buyer's costs and obligations under the Power Sale Agreement between Pinnacle West Capital Corporation ("Seller") and Citizens Communication Company ("Buyer"); including Section 1.9 - Valencia Turbines, which states that "Seller (Pinnacle West) shall have full authority, control, and responsibility for determining the times and reasons for the operation of the Buyer's (City of Nogales) Valencia Turbines".

7) The assets purchase agreement is subject to the approval of the Arizona Corporation Commission.

Again Marco, I have offered these two proposals at your request. However, I do not believe the second proposal, a purchase of assets by the City of Nogales, is in the customers' best interest. UniSource continues to believe that its proposed settlement before the Arizona Corporation Commission more appropriately addresses the needs of the citizens of the City of Nogales and Citizens' current electric and gas customers.

I look forward to discussing this matter with you further.

Very truly yours,

James S. Pignatelli

JSP:lhk

CITY OF
NOGALES

OFFICE OF THE CITY ATTORNEY

MARCO A. LÓPEZ, JR.
Mayor

JOSE LUIS MACHADO
City Attorney

March 11, 2003

Mr. James S. Pignatelli
Chairman, President & Chief Executive Officer
UniSource Energy Corporation
1 South Church Avenue
Mail Stop UE 181
P.O. Box 711
Tucson, AZ 85702

Re: City of Nogales Electric and Natural Gas Utility Service

Dear Mr. Pignatelli:

Thank you for your letter dated February 7, 2003, setting forth the terms of a franchise fee proposal and an asset purchase proposal with respect to the above-referenced matter. On behalf of the Mayor and City Council of the City of Nogales, I am writing in response to your proposals. For ease of reference, this response corresponds numerically to the items set forth in your correspondence.

I. **Franchise Fee Proposal**. The City is willing to consider a franchise agreement with UniSource on an interim basis. As we advised both UniSource and Citizens Communication Company ("Citizens") previously, it is the City's desire – and intent – to acquire ownership of both the electric and gas utilities which currently provide service within the City. Until such time as those acquisitions can be completed, the City is willing to allow its voters to consider the approval of a franchise agreement of not more than 10 years with a four-percent (4%) franchise fee. The franchise fee will be payable by UniSource from the revenues it derives from services provided, not through a separate charge levied against the Nogales-based customers of UniSource. Pursuant to Arizona statute, UniSource will bear the costs of the franchise agreement election. By separate correspondence from outside counsel, the City will respond to the remaining terms of the franchise agreement UniSource has proposed.

II. **Asset Purchase Proposal**. In response to your proposal, the City offers to purchase the electric and gas capital facilities located within the boundaries of Santa Cruz County, as follows:

1. Purchase price for the electric transmission and distribution assets to be determined based on (i) the price being paid by UniSource to Citizens for those facilities; (ii) an examination to be

undertaken by the City with respect to the historical books and records kept and maintained of the revenues received and expenses incurred in the operation of those facilities for the last three (3) years; and (iii) a physical inspection by the City's consultant of the distribution assets to be acquired. In order to facilitate the books and records examination, UniSource must agree to make those books and records available for examination and analysis by the City's experts/consultants and counsel. An appropriate (and permissible under the State Public Records Law) confidentiality agreement will be executed by the City in order to guarantee the confidentiality of certain information provided to the City.

2. At this juncture, the City has no interest in acquiring any existing electric generation assets located in the City or in nearby locations outside the City.

3. Pursuant to order of the Arizona Corporation Commission ("Commission") construction of the 345 kV auxiliary transmission line is – and will remain – the responsibility of Citizens/UniSource. The City will not pay for the costs of that construction. Further, if construction of that transmission line is not completed by UniSource/Citizens within the time period established by the Commission, the City will seek to enforce the order and/or obtain compensation for any damages attributable to the construction completion delay.

4. Non-emergency interim system improvements shall be made by UniSource after consultation with the City. For such improvements as to which the City gives prior approval, the City will pay an incremental amount attributable thereto in connection with the City's acquisition of each utility (electric and gas). UniSource shall provide the City with documentation sufficient to enable the City to confirm the actual cost attributable to the relevant interim improvements.

5. In connection with its acquisition of the subject utilities, the City will issue a request for proposals to interested, qualified operators. UniSource will be notified and afforded an opportunity to respond to the RFP. After receipt and evaluation of the responses, the City will select the operator(s) with whom to enter into an operating agreement.

6. The City will not assume the rights or obligations of UniSource or Citizens under any existing power Sale Agreement with Pinnacle West or any other electric power supplier. Rather, the City will enter

into Power Sale Agreements with suppliers under terms that are beneficial to the residents/customers of the City.

7. If the City's acquisitions are completed by consensual agreement, they will be subject to the Commission's approval. In the event that a mutually acceptable agreement cannot be achieved, it is the City's current intention to pursue acquisition of the utilities through the exercise of the City's power of eminent domain.

In closing, the City appreciates your proposal as an initial expression of UniSource's willingness to pursue the negotiations necessary to avoid what is otherwise likely to be a lengthy, expensive and divisive acquisition process. Please understand, however, that the elected representatives of the City and I as the City Attorney have an obligation to ensure that the residents of our community receive the best possible electric and gas service at the lowest possible cost. History has proven that those objectives were not achieved through private ownership and operation of the utilities. The time has come for the City to diligently pursue direct local public control.

We look forward to discussing the details of this matter with you at your earliest opportunity.

Very truly yours,

Jose L. Machado
City Attorney

JLM/ygs

c: Nogales City Council

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