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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation 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 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

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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

JOINT APPLICANTS' POST-HEARING BRIEF

Joint Applicants, Citizens Communications Company ("Citizens") and UniSource Energy Corporation ("UniSource"), on behalf of itself, its designated affiliates, and Tucson Electric Power Company ("TEP"), submit this Post-Hearing Brief in support of their Joint Application and the Settlement Agreement ("Settlement Agreement") between UniSource, TEP, Citizens, and the Staff of the Utilities Division of the Arizona Corporation Commission ("Staff").

UniSource's purchase of Citizens' Arizona electric and gas assets provides unquestioned benefits to Arizona. The Settlement Agreement presents the Arizona Corporation Commission ("Commission") with a valuable opportunity to resolve important and complicated regulatory issues in the public interest. Local control, reduced rate base resulting in reduced revenue requirements, forfeiture of the more than $135 million PPFAC balance, elimination of lengthy and costly regulatory proceedings, consolidation and coordination of existing operations, and valuable commitments to a three-year rate moratorium and to retail competition all hinge on approval of the Settlement Agreement. This case is unique: ordinarily a purchaser of utility assets is seeking to collect a return from ratepayers on the premium paid for the assets. In this case, UniSource is passing through the benefits of a discounted purchase price. Both the Staff and RUCO, two parties charged with evaluating the public interest, concur that this sale is in the public interest.

Understandably, customers do not like rate increases, but the rate increases in the Settlement Agreement are fair and reasonable, justified by overwhelming (and often uncontested) evidence and are significantly less than the rate increases proposed by Citizens.

Failure to approve the Settlement Agreement will result in renewed, costly litigation over the PPFAC balance and the gas rate case and will force Citizens to remain in the electric and gas business, contrary to its business plan and focus. The record is absolutely clear: the Arizona public, and Citizens' customers and employees in particular, will be better off as a result of this Settlement Agreement.

Joint Applicants submit that the Settlement Agreement, as supported by the record in this proceeding, achieves a fair and reasonable balance of the diverse issues raised by the Joint Application, provides substantial benefits for electric and gas customers in Citizens' certificated areas, is in the public interest, and should be approved.

I. PROCEDURAL HISTORY

In the Joint Application, UniSource and Citizens requested the consolidation of the approval of the sale and transfer of Citizens' gas and electric assets with Citizens' pending gas rate case (Docket No. G-01032A-02-0598) ("Gas Rate Case") and Citizens' pending purchased power and fuel adjustment clause case (Docket No. E-01032C-00-0751) ("PPFAC Case"). The consolidation of these proceedings and the resolution of the PPFAC Case and the Gas Rate Case prior to the closing of this transaction provides meaningful benefits to customers and is critical to the consummation of this transaction.

See Pignatelli Cross-Examination, Tr. at 75:22-76:3; 76:9-25.[1] Recognizing the interdependence of these proceedings, the Administrative Law Judge's February 7, 2003 Procedural Order consolidated these cases and provided a framework for the parties to attempt to reach a settlement.

All parties to this proceeding first met to discuss the Joint Application and the settlement process on January 13, 2003. *See* Exhibit S-1, at 1:19-20. Additional meetings, during which each of the parties discussed their concerns with the Joint Applicants, occurred on January 22, 2003 and January 31, 2003. *See id.* at 1:21-22. At the January 31 meeting, Staff indicated to the intervenors that it intended to meet separately with the Joint Applicants in an attempt to negotiate a settlement. *See id.* at 2:2-4. Staff and the Joint Applicants encouraged the intervenors to meet separately with the Joint Applicants. None of the intervenors objected to this procedure. *See* Glaser Cross-Examination, Tr. at 142:24-143:3; Jaress Direct, Tr. at 287:19-20; Statement of Mr. J. White, Tr. at 336:4-16. The Joint Applicants then met with Mohave County, Santa Cruz County, RUCO, Mr. Magruder, and the City of Nogales to continue the dialogue on issues important to the respective intervenor. *See* Glaser Direct, Tr. at 125:20-126:6. Indeed, many of these discussions were a continuation of meetings held with the intervenors prior to filing the Joint Application. *See* Glaser Cross-Examination, Tr. at 125:6-10.

On March 31, 2003, all of the parties again convened to discuss the settlement reached by the Joint Applicants and Staff. *See* Exhibit S-1, at 2:4-6. Following that meeting, the Joint Applicants filed the signed Settlement Agreement to allow comment by all parties through pre-filed testimony or statements of position. Ultimately, as evidenced by the limited nature of the issues raised by the intervenors in pre-filed testimony and comments and at the hearing, the Settlement Agreement resolved many of

[1] Citations to "Tr." in this Brief refer to the transcripts of the hearing. Transcript citations and specific citations to exhibits are included in the accompanying Appendix to this Brief.

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the issues and concerns raised by the intervenors. *See* Exhibits RUCO-1, AUIA-1, Diaz Cortez Cross-Examination, Tr. at 541:16-543:14. Although it was not possible to satisfy all of the intervenors on each of their respective issues, Joint Applicants submit that the Settlement Agreement, when taken as a whole, properly balances the diverse interests of the parties, is in the public interest, and should be approved.

II. THE SETTLEMENT AGREEMENT AND ITS BENEFITS

The Joint Application and the Settlement Agreement address numerous issues, including the sale and transfer of Citizens' assets, the financing of the transaction by UniSource, and the resolution of the Gas Rate Case and the PPFAC Case. As Staff has testified, these issues are inextricably linked and the resolution of these issues, as detailed in the Settlement Agreement, "reasonably balances diverse interests, is fair to ratepayers and consistent with the public interest." Exhibit S-1, Executive Summary at 3; Jaress Direct, Tr. at 286:10-13.

This transaction and the commitments set forth in the Settlement Agreement provide numerous benefits, including:

- Significant gas and electric facilities, operations and customers in both northern and southern Arizona will become the responsibility of UniSource, an Arizona-based company that is well known, accessible and held in high regard by the community.
- The benefits from the reduced purchase price of the gas and electric assets will flow through to Citizens' gas and electric customers and will result in lower rates than these customers would likely experience if this transaction is not consummated.
- The Settlement Agreement resolves the long-standing PPFAC Case and provides enormous benefits to electric customers through the forfeiture of any recovery from those customers of the PPFAC balance existing at the time of closing of the transaction, which is estimated to be more than $135 million.

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- UniSource will retain substantially all the Arizona-based employees of Citizens, which will minimize any negative economic impact of this transaction.
- UniSource has committed to a three-year moratorium on the filing of a general gas or electric rate case.
- UniSource has committed to establishing a procedure to open Citizens' electric service territories to competition by December 31, 2004.
- UniSource has committed to submitting a study and plan for the consolidation or coordination of the Santa Cruz electric operations with TEP.
- UniSource has committed to continued pipeline and operational safety standards of the highest quality.
- Finally, UniSource has committed to ensure joint efforts by TEP and the new electric company to comply with the Environmental Portfolio Standard.

A. Transfer of Citizens' Gas and Electric Assets to UniSource

At the core of these consolidated proceedings is the sale and transfer of Citizens' Arizona gas and electric assets, including its Certificates of Convenience and Necessity, to UniSource. Through this proceeding, UniSource has demonstrated that this transfer is in the public interest and that UniSource is a fit and proper entity to purchase and to operate these assets. *See* Exhibit JA-1, at 2:21-3:12; Jaress Direct, Tr. at 286:14-17; Diaz Cortez Direct, Tr. at 537:6-9; Meek Direct, Tr. at 512:15-19. UniSource is an Arizona-based company that is well known, accessible, and held in high regard by the community. *See* Exhibit JA-1, at 2:24-3:2. Similarly, UniSource is experienced in providing quality utility service to Arizona customers and will continue to provide that service to Citizens' customers. *See id.* Recognizing the significant benefits that this transaction will provide, there is no question that UniSource is a fit and proper entity to purchase and to operate Citizens' Arizona gas and electric assets. As Ms. Diaz Cortez confirmed: "[RUCO] found that the sale and transfer was in the public interest [and] that

UniSource was a reputable, reliable, and known entity to run the former Citizens electric and gas properties." Diaz Cortez Direct, Tr. at 537:6-9.

For these reasons and other reasons supported in the record, the transfer of Citizens' gas and electric assets to UniSource should be approved.

B. Gas Rate Case and Other Gas-Related Issues

1. Resolution of the Gas Rate Case

Citizens' amended Gas Rate Case filing made in August 2002 proposed a total rate base of approximately $150 million and an increase in the annual revenue requirement for its Arizona operations of more than $21 million or approximately 28.9 percent. *See* Exhibit JA-6, at Appendix B, Sch. 1; Mason Direct, Tr. at 462:7-13. As confirmed by Staff, these amounts are not inflated, and the requested increase is largely attributable to additions to gross plant in service, the majority of which arose as a result of the Commission-ordered Build-Out Program. *See* Exhibit S-1, at 12:14-22; Dittmer Direct, Tr. at 290:1-8.

Despite the reasonableness of Citizens' request, the Settlement Agreement greatly reduces the increase requested in Citizens' Gas Rate Case filing. These reductions result primarily from the negotiated purchase price of the gas assets, as well as an agreement to permanently write down the gas plant in service by $10 million based on Staff's review of the prudence of the Build-Out Program. *See* Exhibit JA-6; Dittmer Direct, Tr. at 290:9-291:12. As a result, the parties to the Settlement Agreement have agreed to reduce the total rate base for the gas assets from $150 million, as proposed and supported by Citizens, to approximately $117 million. *See* Exhibit JA-6, at Appendix B, Sch. 1. In addition, the revenue requirement increase proposed in the Settlement Agreement is $15,191,276—a reduction of approximately $6 million from the annual increase proposed and supported by Citizens. *See id.* The Settlement Agreement further proposes a fair value rate base of $142,132,013 and a rate of return of 7.49 percent on that

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fair value rate base. *See* Exhibit JA-6, at 13. To implement the increased revenue requirement, the Settlement Agreement includes a rate design supported by Staff, with input from RUCO, which will spread the increase evenly across all retail rate classes. *See* Exhibit JA-6, at Appendix B, Sch. 3; Dittmer Direct, Tr. at 292:23-25.

The rate base and revenue requirement amounts proposed in the Settlement Agreement incorporate a cost of debt of 7.75 percent, a cost of equity of 11 percent, and a weighted average cost of capital of 9.05 percent. *See* Exhibit JA-6, at Appendix B, Sch. 1. The cost of debt proposed by the Joint Applicants is reasonable when viewed in relation to the debt costs for similarly-rated utilities and in light of the relatively small size of the bond issuances for these companies. *See* Exhibit JA-7, at 16:17-17:21. Similarly, although the actual cost of equity for the new companies may be higher in light of prevailing circumstances in the energy industry, UniSource agreed to the 11 percent cost of equity proposed by Citizens in its original filing. *See* Exhibit JA-7, at 18:1-7. Finally, although the weighted average cost of capital of 9.05 percent proposed in the Settlement Agreement is slightly higher than that proposed by Citizens, Staff analysis confirms that, on a pre-tax basis, the cost of capital proposed in the Settlement Agreement results in a lower revenue requirement than that proposed by Citizens. *See* Exhibit S-1, at 25. These assumptions, when viewed together with the reduced rate base, provide a substantial benefit to customers and allow UniSource to earn a reasonable return.

2. Benefits to Gas Customers

The benefits of the purchase of the gas assets by UniSource are well documented in this proceeding. Because UniSource is purchasing the gas assets from Citizens at a price well below their net book value, Citizens' gas customers will benefit greatly from the corresponding long-term reduction in rate base. *See* Dittmer Direct, Tr. at 290:14-18. As Mr. Dittmer explained, the purchase of these types of assets below book value is highly unusual, as is the pass through of such savings to customers. *See* Dittmer

Direct, Tr. at 290:19-291:2. In addition to the decreased purchase price, the parties to the Settlement Agreement negotiated an additional $10 million reduction in the recorded cost of the gas plant attributable to the Build-Out Program. *See* Exhibit JA-6, at 18. These concessions by UniSource provide for a net utility plant in service value that is more than $40 million below the amount requested and supported by Citizens in its Gas Rate Case filing. *See* Exhibit JA-6, at Appendix B, Sch.1. In other words, gas customers will ultimately pay through rates only $35 million of the approximately $75 million spent by Citizens on the Build-Out Program. *See* Glaser Cross-Examination, Tr. at 188:11-15.

Under the terms of the Settlement Agreement, Citizens' gas customers will enjoy the significant benefits of the Build-Out Program and other capital improvements at a significant discount from the actual cost of those improvements. As a result, the requested annual revenue increase proposed by Citizens is reduced by approximately $6 million, and Citizens' proposed monthly service charge for residential customers of $10.00 is reduced to $7.00. *See* Exhibit JA-6, at Appendix B, Sch. 1, 3. Although the increase in gas base rates is not insignificant, it is important to note that customers of the Santa Cruz division have not experienced a rate increase since 1987, and customers of the northern division have not experienced a rate increase since 1996. *See* Exhibit S-1, at 8:11-13; Dittmer Direct, Tr. at 289:21-25. Furthermore, following the increase approved in the Settlement Agreement, gas customers will experience stability in base rates, as UniSource has agreed in the Settlement Agreement to a three-year moratorium on the filing of a future rate case. *See* Exhibit JA-6, at 19. A further benefit of the transaction is the consolidation of the northern and southern gas divisions, which should allow for certain administrative efficiencies and would extend to gas customers in Santa Cruz County low-income programs currently available only to customers in the northern division. *See* Glaser Direct, Tr. at 127:16-19; Glaser Cross-Examination, Tr. at 257:18-22.

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C. PPFAC Case and Other Electric-Related Issues

In addition to the many benefits of this transaction for gas customers, this transaction provides significant benefits for electric customers through the resolution of the PPFAC Case and other commitments made by UniSource. Citizens first filed its PPFAC Case in September of 2000. In that filing, Citizens requested full recovery of the under-recovered balance for purchase power costs incurred under the 1995 contract ("Old Contract") between Citizens and APS. *See* Exhibit S-1, at 33:1-9. In an amended filing, Citizens also requested a PPFAC surcharge to recover the costs under the 2001 contract ("New Contract") between Citizens and Pinnacle West Capital Corporation ("PWCC"). *See id.* The PPFAC Case involved detailed analysis by all parties involved and many complex issues relating to the treatment of those under-recovered amounts.

1. Resolution of the PPFAC Case

As part of the Settlement Agreement, UniSource has agreed that it will not pursue recovery from retail customers of the PPFAC balance existing at the date of closing of the purchase. *See* Exhibit JA-6, at 15. Currently, the parties estimate that this amount will be approximately $136.8 million. *See* Glaser Direct, Tr. at 128:18-21. As a result, electric customers, who have not experienced an increase in power costs since 1997, will have paid much less during this period than the cost of power that they have consumed. *See* L. Smith Direct, Tr. at 298:9-15. Indeed, as explained by Staff, given the increase in power costs, it is "surprising that [customers] did not experience increases several years ago or maybe several increases." L. Smith Direct, Tr. at 309:16-20.

Although much discussion in this proceeding has focused on the prudence of the Old Contract, the Settlement Agreement makes those issues moot, as UniSource has agreed not to pursue those amounts from retail customers. However, this should not diminish the importance of UniSource's agreement not to pursue recovery of those amounts from retail customers. Indeed, if this transaction does not close, Citizens has vowed to continue to pursue full recovery of the PPFAC balance. *See* McCarthy Cross-Examination, Tr. at 467:13. Under Citizens' proposal for recovery in the PPFAC Case, rates would increase by more than 40 percent. *See* RUCO-1, at 3:4-5; Jaress Cross-Examination Tr. at 328:4-5; 343:13; 344:6-7. As Staff explained, under a "best case" scenario for customers, rates under the PPFAC would increase by approximately 27 percent. *See* L. Smith Cross-Examination, Tr. at 345:5-7; 345:11-12. Because UniSource has agreed to forego recovery of the PPFAC balance existing at the time of closing, the rate increase under the Settlement Agreement will be approximately 22 percent. *See* Exhibit JA-6, at 15; L. Smith Direct, Tr. at 309:1-5.

To account for the increase in power costs, the Settlement Agreement sets a new PPFAC adjustor of $0.01825 per kWh, with the base rate remaining at $0.05194 per kWh. *See* Exhibit JA-6, at Appendix C. Although the increase under the Settlement Agreement is not insubstantial, the increase is "quite justified" as it represents an increase in the cost of power experienced by Citizens under the New Contract. *See* L. Smith Direct, Tr. at 309:4-5. Based upon a detailed analysis, Staff has concluded that the cost of power under the New Contract is reasonable. *See* L. Smith Direct, Tr. at 304:24-25. RUCO's analysis also confirmed that, on a going-forward basis, the cost of power under the New Contract is reasonable and that the increases to the PPFAC adjustor rate are cost-based. *See* Diaz Cortez Cross-Examination, Tr. at 549:14-20; 576:11; Diaz Cortez Re-Direct, Tr. at 577:12.

The detailed testimony presented and analysis conducted by Mr. DeConcini support the same conclusion. *See* Exhibit JA-9; DeConcini Cross-Examination, Tr. 165:7; 196:9-13. In his analysis, Mr. DeConcini explained that the New Contract is a full-requirements supply agreement, which requires PWCC to meet the instantaneous demand of Citizens' customers for a price of $58.79 per MWh. *See* Exhibit JA-9, at 2:18-19; DeConcini Direct, Tr. at 138:15-25. Mr. DeConcini's analysis provides three bases for comparison. First, when compared to other comparable power contracts signed in 2001, which had prices ranging from $60 per MWh to $165 per MWh, the New Contract price of $58.79 per MWh is reasonable. *See* Exhibit JA-9, at 4:18-5:19; DeConcini Direct, Tr. at 139:22-140:10. Second, when compared to a cost of power of $55 to $65 per MWh, which Citizens would have paid in 2001 had it built a combined cycle unit to provide power or had a third party build such a unit, the New Contract is reasonable. *See* Exhibit JA-9, at 5:22-6:8; DeConcini Direct, Tr. at 140:11-22. Finally, when compared to the same range of $55 to $65 per MWh if Citizens were to build the same type of combined cycle unit in today's market, the New Contract is reasonable. *See* Exhibit JA-9, at 8:23-9:16; DeConcini Direct, Tr. at 140:23-141:3. As Mr. DeConcini explained, because two years of the existing PPFAC balance that will be forfeited relate to the New Contract—a contract that has proven to be reasonable—electric customers receive an enormous benefit from the forfeiture of any recovery for this period. *See* DeConcini Cross-Examination, Tr. at 184:11-15; L. Smith Direct, Tr. at 304:24-25.

2. Other Benefits of the Transaction

In addition to the benefits relating to the forfeiture of more than $135 million of the PPFAC balance, electric customers will benefit from stable power costs for the remaining life of the New Contract. *See* Exhibit S-1, at 32:1-2. Furthermore, if UniSource successfully renegotiates the contract with PWCC, customers will receive sixty percent of the savings under the renegotiated contract. *See* Exhibit JA-6, at 15-16. The Settlement Agreement also provides for a permanent reduction in the electric rate base reflecting the negative acquisition adjustment resulting from the discounted purchase price, which will provide benefits to electric customers in future rate cases. *See* L. Smith Direct, Tr. at 297:12-16. RUCO's estimate of the impact of this write down is a reduction of approximately $17 million to the annual electric revenue requirement. *See* RUCO-1, at 4:19-20. Similarly, as with gas rates, UniSource has agreed to a three-year moratorium on the filing of an electric rate case. *See* Exhibit JA-6, at 19. Finally, UniSource has agreed to complete a feasibility study for the consolidation or coordination of the Santa Cruz electric operations of the new company with the operations of TEP and to establish a process to open the new company's electric service territory to competition by December 31, 2004. *See* Exhibit JA-6, at 8-9. These benefits would not arise without the purchase of the assets by UniSource and, therefore, provide overwhelming evidence that the approval of the Settlement Agreement is in the public interest.

3. Other Issues Raised by Intervenors

Although supporting the majority of the Settlement Agreement, RUCO has raised two issues relating to electric operations. First, RUCO requests an increase in funds used for demand side management ("DSM") from $175,000 to $600,000 (and possibly $1 million if the New Contract is renegotiated). Although UniSource agrees that the efficient use of electricity is a worthwhile and important goal, there are differences in opinion as to the best means to achieve this goal. *See* Exhibit JA-5, at 3:10-13. Currently, Citizens' per customer funding for DSM is comparable to the level of funding for DSM activities by other electric utilities in Arizona. *See* Exhibit JA-5, at 6. RUCO's proposal would greatly inflate DSM spending and would result in upward pressure on rates—the very issue that RUCO seeks to avoid. *See* Glaser Direct, Tr. at 130:18-25; Glaser Cross-Examination, Tr. at 167:17-21. As Ms. Diaz Cortez testified, this upward pressure on rates would occur "whether [the DSM programs] worked or they didn't." Diaz Cortez Cross-Examination, Tr. at 573:9-10.

As discussed by Mr. Glaser, the Commission has shifted its focus from funding DSM programs to market-based solutions and to the development of renewable energy resources. *See* Exhibit JA-5, at 3:20-22. In light of this shift and the Commission's direction to explore DSM issues in the Track B workshops, it is premature to address these issues in this proceeding. *See* Glaser Cross-Examination, Tr. at 130:16-

25. UniSource has committed to work with RUCO and other interested parties to re-allocate the DSM funds to more effectively use those funds to benefit customers. *See* Exhibit JA-5, at 6:20-22. However, until the Commission provides more direction on the issue of DSM, UniSource submits that the current level of DSM funding is appropriate.

RUCO and other intervenors also challenge the sharing of any savings of a renegotiated power contract with PWCC. UniSource submits that the sharing is appropriate to continue to achieve the balancing of interests set forth in the Settlement Agreement. This issue cannot be viewed on a stand-alone basis. As Staff explained, the parties negotiated many diverse issues, including the sharing of savings, and any modification to this provision will upset the balance struck by the parties to the Settlement Agreement. *See* Jaress Direct, Tr. at 330:20-23. Given the substantial benefits achieved for customers, this issue must be viewed "as part and parcel of the entire settlement package" and should not be revised. Exhibit JA-5, at 3:4-6.

Other intervenors also raised the issue of the transmission line between Tucson and Nogales approved in Decision No. 64356. The Joint Applicants have maintained throughout this proceeding and continue to maintain that the transmission line is not an issue in this proceeding and will be addressed in another docket at the appropriate time. *See* Pignatelli Cross-Examination, Tr. at 114:16-23. Similarly, the issue of franchises to provide electric service has been raised in this proceeding. The Settlement Agreement appropriately requires UniSource to file copies of appropriate franchises, licenses and other similar authorizations to the Commission within 365 days of approval of the transfer. *See* Exhibit JA-6, at 8. Such a provision is standard in Commission orders and allows the Joint Applicants the necessary time to procure and to process the assignment of these authorizations. *See* Jaress Cross-Examination, Tr. at 354:16-27. If UniSource is unable to meet this condition within 365 days, it is wholly appropriate for UniSource to return to the Commission so that the Commission may address the issue at that time. *See* Jaress Cross-Examination, Tr. at 356:14-17. The Commission should reject the City of Nogales' self-serving suggestion that a penalty should be automatically imposed. *See* City of Nogales Opposition to Proposed Settlement Agreement (April 21, 2003), at 1-2.

D. Financing the Transaction

The Settlement Agreement provides UniSource with the necessary flexibility to consummate this transaction in a timely and cost-effective manner, while ensuring the continued success and viability of the new electric and gas companies and TEP. *See* Exhibit JA-7, at 2:20-21; Larson Direct, Tr. at 132:11-15. UniSource intends to create an intermediate holding company ("HoldCo") and two operating companies—one to operate the electric assets ("ElecCo") and one to operate the gas assets ("GasCo"). *See* Exhibit JA-6, at 7-10. UniSource intends to target the two operating companies for a 60/40 debt-to-equity ratio. *See* Larson Direct, Tr. at 149:5-18. To provide incentive for the companies to achieve this ratio, the Settlement Agreement provides that GasCo and ElecCo shall not issue dividends to HoldCo or to UniSource that total more than seventy-five percent of their respective earnings until equity capitalization equals forty percent of total capital. *See* Exhibit JA-6, at 12-13. In good faith, TEP agreed to the same restriction, which modifies a lesser equity capitalization threshold of 37.5 percent from a prior Commission order.[2] *See id.* at 13.

Under the terms of the Settlement Agreement, the new companies are authorized: (1) to issue or to guarantee up to $175 million of debt securities in order to fund a portion of the acquisition or to refinance any bridge financing used to fund the acquisition; (2) to issue or to guarantee additional debt securities, when appropriate, under

[2] At the hearing, the issue of a graduated dividend structure was discussed. UniSource objects to such a structure and believes that such a structure is not appropriate in this proceeding. *See* JA-8, at 7:3-11.

the terms of a new revolving credit agreement that would provide ongoing liquidity support; (3) to enter into indentures or security agreements which grant liens on some or all of the properties held by the new companies to secure the debt obligations of the new companies; (4) to issue common stock to UniSource or to HoldCo; and (5) to acquire bridge financing to fund all or a portion of the acquisition on an interim basis in an amount not to exceed $250 million. *See* Exhibit JA-6, at 10-12; Appendix A.

The bridge financing would allow UniSource to close this transaction if the long-term capital market is not favorable at the time of closing. *See* Larson Direct, Tr. at 133:13-22. The amounts approved for interim bridge financing and the amounts approved for long-term bond financing are not additive. Rather, the funds from the long-term bond financing will be used to pay off any interim bridge financing. *See* Exhibit JA-6, at Appendix A; Jaress Cross-Examination, Tr. at 317:25. Furthermore, although the Settlement Agreement allows the new companies to enter into a revolving credit agreement in an amount not to exceed $50 million, the use of the revolving credit agreement will be for short-term liquidity needs of the utility. *See* Jaress Cross-Examination, Tr. at 318:16; Thornton Cross-Examination, Tr. at 442:21-23. As explained by Staff and by UniSource, the revolving credit facility will address seasonal cash flow issues, such as those relating to increased gas prices, and will not be used to fund the initial purchase price. *See* Larson Cross-Examination, Tr. at 263:8-12; Jaress Cross-Examination, Tr. at 318:12. The use of a revolving credit agreement is standard in the utility industry and allows utilities to address short-term cash flow needs. *See* Jaress Cross-Examination, Tr. at 318:8.

In addition to the financing described above, the Settlement Agreement authorizes TEP to loan up to $50 million to UniSource to provide UniSource with the necessary flexibility to close this transaction. *See* Thornton Direct, Tr. at 313:17-19. TEP has sufficient cash flows to provide the loan to UniSource, and the loan will not have an adverse impact on TEP. *See* Larson Cross-Examination, Tr. at 146:25-147:5; 170:8-11. Despite this, TEP has agreed to certain restrictions on the loan to benefit its customers and to ensure that its customers are held harmless from the loan. For example, the loan will be secured with one hundred percent of the common equity of HoldCo or the new companies, the term of the loan is limited to four years, and the Settlement Agreement requires UniSource to pay interest on the loan at a rate of 383 basis points above the rate on an equivalent U.S. Treasury security. *See* Exhibit JA-6, at 10-11. The agreement also requires TEP to use 262 basis points of the interest income as a credit to customers to reduce rates in the future. *See id* at 11. The remaining interest income will be used to build TEP's equity capitalization. *See id.* As an added protection, the Settlement Agreement provides that TEP customers will be held harmless from any increase in the cost of capital as a result of the loan. *See id.*

The financing plan set forth in the Settlement Agreement provides UniSource with the necessary flexibility to close this transaction and to adequately capitalize the new companies. Although the Joint Applicants appreciate the concerns regarding the financing raised during this proceeding, they submit, as did Staff, that the financing plan proposed is necessary to close this transaction in a timely and cost-effective manner and that the substantial benefits provided by this transaction make the approval of this financing plan in the public interest. *See* Thornton Direct, Tr. at 314:4-8.

III. RELIEF REQUESTED/CONCLUSION

For the reasons set forth above, Joint Applicants request the approval of the Settlement Agreement and all necessary approvals for the transactions contemplated in the Settlement, including:

- necessary approvals pursuant to A.R.S. § 40-285 for Citizens to transfer its Arizona gas assets and electric assets, including its Certificates of Convenience and Necessity, to UniSource and for ElecCo and GasCo to encumber the gas assets and electric assets for financing purposes;

- necessary approvals pursuant to A.R.S. §§ 40-301 *et seq.* for the financing of the transaction, including bridge financing, bond financing, and revolving credit financing by ElecCo and GasCo and the issuance of stock by those companies, including, but not limited to, appropriate findings pursuant to A.R.S. §§ 40-301.C and -302.A.
- necessary approvals pursuant to A.A.C. R14-2-801 *et seq.* for the loan from TEP to UniSource;
- necessary approvals under A.A.C. R14-2-801 *et seq.* for the capitalization of ElecCo and GasCo;
- waiver of that portion of Decision No. 60480, as amended by Decision No. 62103, that requires UniSource to invest thirty percent of the proceeds of a public stock issuance in TEP so that UniSource may fund this acquisition;
- approval of the increased revenue requirement for GasCo, the new rate design for GasCo, and a tariff modification relating to the service line and main extension policy, all as set forth in the Settlement Agreement;
- a fair value rate base finding of $142,132,013 and a rate of return on the fair value rate base of 7.49 percent in the Gas Rate Case;
- approval of a new PPFAC adjustor of $0.01825 per kWh;
- approval to recover certain asset acquisition costs as an offset to the negative acquisition premium; and
- all other approvals necessary to approve the Settlement Agreement and to consummate the transactions contemplated in the Joint Application.

LEWIS AND ROCA LLP

LAWYERS

Respectfully submitted this 15th day of May, 2003.

LEWIS AND ROCA LLP

By ______________________

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BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman

JIM IRVIN
Commissioner

WILLIAM A. MUNDELL
Commissioner

MIKE GLEASON
Commissioner

JEFF HATCH-MILLER
Commissioner

Arizona Corporation Commission
DOCKETED
MAY 15 2003
DOCKETED BY

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2003 MAY 15 P 3: 29
AZ CORP COMMISSION
DOCUMENT CONTROL

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

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

JOINT APPLICANTS' POST-HEARING BRIEF

APPENDIX

May 15, 2003

1399384.1

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DeConcini

At: Phoenix, Arizona

Date: May 1, 2003

Filed: MAY - 7 2003

REPORTER'S TRANSCRIPT OF PROCEEDINGS

VOLUME I
(Pages 1 - 275, inclusive)

ARIZONA REPORTING SERVICE, INC.
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Suite Three
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Phoenix, Arizona 85004-1103

By: DAWNA J. BOSWELL, RPR
Certified Court Reporter
Certificate No. 50326

Prepared for:

CITIZENS AND UNISOURCE

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Additionally, a lot of people like to utilize power market index prices to estimate the relevance or the reasonableness of power prices, and first, as I've already stated, you have to look at time and compare the relative, an index that meets the time when you need the power. In addition to that, however, those price indexes tend to relate to power that's purchased in blocks. In reality, people demand their power in much smaller increments than those blocks represent. They want their power to be there when the air conditioning goes on or when the lights go on, and there are costs above those index prices that are incurred by utilities in fully serving the demand of their customer base.

With those three key points, I will move on to talking briefly about the Pinnacle West agreement with Citizens. The Pinnacle West agreement with Citizens was signed in May or June of 2001. It runs through May of 2008. It is a full requirement supply agreement. What that means is all of those elements that I discussed in my opening are included in that agreement, and Pinnacle West is thus required to meet the instantaneous demand of Citizens' customers whenever they happen to turn on those lights or air conditioners. Conversely, when they turn those things off, Pinnacle West needs to take the power back. In exchange for this obligation, Pinnacle West receives $58.79 per megawatt hour.

And there's a couple other important factors I want to mention. Because that price is fixed and power markets have been fairly volatile, there's a benefit to Citizens' customers in that the power price risk is all to the benefit of Pinnacle West. Additionally, all the operational risk of delivering the power is also in Pinnacle West's hands. And a last beneficial point is that as Steve has mentioned and I believe Jim Pignatelli also mentioned earlier, per our settlement, we're required to open the Citizens customer base to competition by the end of 2004. The structure of the existing Pinnacle West agreement allows for that to occur with no penalty to Citizens or its customers, and we think that's important as well.

Now, you ask how did I look at this agreement and determine whether the pricing was reasonable. I looked at it in three different ways that I'll discuss briefly now. First, the first two I looked at were in the time frame in 2001 when the agreement was signed, and I think it's most relevant to look at the time frame in which the contract was signed and where the markets were at that time. The first measure was to look at other contracts that were signed in the marketplace for either similar terms to the Pinnacle West agreement or in some cases longer terms. And you may recall some of the California situation was at a head at that point in time and the State of California was signing many long-term agreements. So there are quite a few comparables out there. The prices in those comparables range from $60 per megawatt hour to $165 per megawatt hour.

An additional look and analysis that we've done to determine the reasonableness in the 2001 time frame is we made the assumption that Citizens either built a combined cycle unit to serve their load or had someone build one for them and purchased the power from them. Then we determined what forward gas prices and power market prices were at that time, and we dispatched that generating unit to meet the load and also dispatched the market against that generating unit when the market was at a better cost point. The results that came out of that study were the price for power in the range of 55 to $65 per megawatt hour.

I've done one additional analysis in today's time frame. We did the same analysis that was done with the combined cycle case and took today's forward gas prices and today's power market prices, and interestingly came up with the same price range of 55 to $65 per megawatt hour for that service.

To summarize, in all the ways that I've looked at the Pinnacle West agreement, the pricing seems to be reasonable, and therefore, I think it's valid to pass those costs on to the retail customers of Citizens.

MR. CAMPBELL: Thank you, Mr. DeConcini.

The UniSource panel is available for cross-examination.

ACALJ NODES: All right. Mr. Gellman, any questions for the panel?

MR. GELLMAN: Yes, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. GELLMAN) Good afternoon, gentlemen.

Mr. Glaser, I'd like to start with you and talk a little bit more about the process. Is it fair to say that you were one of the principals involved, not just in the January meetings involving all the intervenors but throughout the negotiation process with Staff as part of this Joint Application?

A. (BY MR. GLASER) Yes, it is. I was the estimate to be the fuel adjustment clause balance, approximately 48 million of that has been accrued since the signing of the new agreement.

Q. So let me summarize your testimony. Is it your testimony that the Pinnacle West contract was prudent when it was negotiated in June of 2001?

A. (BY MR. DeCONCINI) Yes, it is.

Q. And is it your testimony that the contract price today is reasonable today and into the foreseeable future?

A. (BY MR. DeCONCINI) Yes, it is.

Q. We've had some odd circumstances in this proceeding since it first began, and so I'm going to ask a couple questions that maybe seem a little odd. They're for the whole panel. Does anybody up there play Saturday night poker with Bill Post or Jack Davis?

A. (BY MR. GLASER) No.

Q. Is anybody married to Bill Post's sister? No?

A. (BY MR. GLASER) No.

Q. Is anybody in a real estate partnership with either of those guys?

A. (BY MR. GLASER) No.

A. (BY MR. DeCONCINI) No.

that's currently being requested as far as that rate, this additional $50 million?

A. (BY MR. DeCONCINI) No, that additional $51 million we are actually also not requesting recovery of in this process. It's part of that $136 million that we're saying, "Okay, all these dollars go away. In exchange, we would like to receive the full cost of the current Pinnacle West agreement in rates." So all the PPFAC including the last 24 months under the new agreement are going away under the settlement. And as I've stated, I believe the contract with Pinnacle West to be reasonable, so if that's reasonable, you're getting a bargain by not having to ever pay for those costs that have been incurred in the last two years.

Q. I think I understand, but to make sure that I understand, the new, the proposed settlement agreement continues that, even though that 50 million is gone, the new Settlement Agreement will contain for the years to come the equivalent of the $50 million that you're including in this forfeiture, PPFAC forfeiture under this agreement?

A. (BY MR. DeCONCINI) It will include those dollars on an annualized basis in the rates, but those dollars won't flow to the PPFAC. There won't be a you looked at putting in your own resource to serve the load and came up with a price in the $60 range, both of which made in my view the contract look reasonable in that time frame.

So I think the conclusion you're trying to draw is that somehow this contract is totally invalid because there is alleged or actually there's found to have been some market manipulation during that time frame. The conclusion I have drawn is that in fact, this contract is reasonable in light of everything that was going on during that time frame, including the market manipulation that is alleged in this, or as determined in this FERC Opinion.

Q. One of the factors you cite on page 12 of your conclusion is the fact, and correct me if I'm not characterizing this properly. I am on line 23 on page 12, that one of the factors that entered into your conclusion was the fact of PWCC and Citizens had equal access to market prices, conditions, and information. If the information they have is somehow tainted by this market manipulation, do you still feel that customers or ratepayers should be responsible for bearing the burden of that erroneous information?

A. (BY MR. DeCONCINI) Yes, because if you read the Staff Report and the conclusion that was supported

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Diaz Cortez

At: Phoenix, Arizona

Date: May 5, 2003

Filed: MAY - 8 2003

REPORTER'S TRANSCRIPT OF PROCEEDINGS

VOLUME III
(Pages 504 through 596)

DISK ENCLOSED

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of the settlement agreement to be that it included a write-off of the $135 million PPFAC liability. The settlement also included a writedown of both the gas and electric rate base. For all time, we might add, not just specifically for the cases in front of us.

We also found that the sale and transfer was in the public interest, that UniSource was a reputable, reliable, and known entity to run the former Citizens electric and gas properties.

However, we found that, unfortunately, the settlement agreement, despite its merits, would result in relatively high rate increases of approximately 21 percent for the gas and 22 percent for the electric, so in my testimony, we proposed two modifications to the settlement agreement which are aimed at mitigating the 22 and 21 percent rate increases, respectively.

The first is we're proposing that UniSource invest in DSM programs which would give Citizens' customers the tools, if you will, to enable them to mitigate a portion, if not all, of the unfortunate result of these rate increases.

Currently, Citizens has $175,000 embedded in its base rates for DSM programs. We're proposing that be increased to 25 million to bring it up to a total of $1 million per year spent on DSM. Appendix 2 of my the Santa Cruz and northern Arizona.

MR. WAKEFIELD: Thank you.

With that I'll move RUCO Exhibit 1, and Ms. Diaz Cortez is available for cross-examination.

ACALJ NODES: Any objection to the admission of the exhibit?

(No response.)

ACALJ NODES: RUCO Exhibit 1 is admitted.

Mr. Campbell, do you have questions for Ms. Diaz Cortez?

MR. CAMPBELL: Just a few. Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. CAMPBELL:

Q. Good morning, Ms. Diaz Cortez. I think it's fair to say that RUCO believes there's much to like in this settlement agreement; would you agree with that?

A. Yes.

Q. In fact, you mentioned that one of the examples was the forfeiture of the large PPFAC balance; is that correct?

A. Yes.

Q. I think another example you mentioned in your summary was reduced rate base; is that correct?

A.   Yes.
Q.   Is it also correct that you actually, in your testimony, calculated that you thought there would be an annual electric revenue requirement reduction of approximately $17 million as a result of the electric rate writedown; is that correct?
A.   Yes.
Q.   And I think you also mentioned as a benefit, there will be a rate moratorium on the electric side; is that correct?
A.   Yes.
Q.   On the gas side, similarly, I think you did an analysis and I think you determined that there would be an annual reduction in gas revenue requirement as a result of this writedown of approximately 5.5 million; is that correct?
A.   Yes.
Q.   And would you agree that there are some additional benefits, following additional benefits to this program, to this settlement agreement? For instance, I think I just heard you say this, there's a benefit from operational consolidation?
A.   Yes.
Q.   Do you believe it's also a benefit that both the new company and TEP have agreed to restriction on the

issuance of dividends till they get 40 percent equity?

A. Yes.

Q. And would you agree it's a benefit that in the settlement agreement there is a required maintenance in quality of service and safety standards?

A. Yes.

Q. And would you agree another benefit of the settlement agreement is that the ratepayers are held harmless from any excess transition costs resulting from any delays in the transfer?

A. Yes.

Q. Would you agree that there are potentials for economies of scale from this transaction?

A. Yes.

Q. Now, with respect to DSM, were you here when Mr. Glaser testified last week?

A. Yes.

Q. Do you remember that Mr. Glaser offered to reconfigure the use of the current DSM amounts if it had to work with other parties such as RUCO to reconfigure the current DSM amounts, if they could be used more effectively?

A. I believe he testified to something similar to that.

MR. CAMPBELL: Thank you. I have no further

Mr. Holub.

MR. HOLUB: Thank you.

CROSS-EXAMINATION

BY MR. HOLUB:

Q. As I understand your testimony, you have two recommendations, the DSM and the reduction in percentage aimed at mitigating the impact on the rate increase on the ratepayers; is that correct?

A. Yes.

Q. Why do you feel there should be a mitigation on the impact to the ratepayers?

A. Because 22 percent is a large increase. Unfortunately, from our analysis, it's cost based and a lot of debate, had we had the PPFAC filing and a lot of these other things would go to the dysfunctional markets during 2000, 2001, and why these price spikes occurred. But the fact remains that they did, and so we were looking at a situation where the costs were incurred, and the costs have to be recovered.

The company has gone a long way to share in the responsibility or mitigation of what would be in writing off the 135 million. But still, 22 is better than 45, but 22 is a lot to ask of people to pay. And I understand that there's proportionately more low income

Q. Ms. Diaz Cortez, I obviously understand that everybody would operate in good faith and try to develop programs that would work, but my question is really kind of a ratemaking, theoretical ratemaking question.
If additional moneys were to be spent on DSM, and if those DSM programs, despite good efforts by everyone, don't work, isn't the result upward pressure on rates in the next rate case?
A. That would be true whether they worked or they didn't.
Q. Thank you.
One final question. Are you aware of the fact that as a part of the Commission agenda, that Staff will be studying in a more generic sense DSM programs during the course of the next year?
A. Could you read the first part of that question?
Q. Are you aware that the Commission, primarily Staff, will be studying DSM programs for a generic proceeding during the course of the next year?
A. Pursuant to?
Q. I think it's just pursuant to an agenda set forth by the Commission. Are you aware of that?
A. No.
MR. CAMPBELL: Thank you. No further

Pinn West, that being the one in 2001? Did you analyze the reasonableness of that agreement?

A. I believe that was done about a year and a half ago, when the PPFAC was proceeding on its own, or the PPFAC docket was proceeding on its own.

Q. Okay. And was it RUCO's conclusion that you agreed with Staff, at least as part of this settlement agreement, that the contract or at least the price set forth therein was a reasonable purchased power agreement on a going-forward basis?

A. Yes.

Q. So RUCO did some form of analysis, came to the conclusion that as Staff found, it was a reasonable contract going into the future?

A. Yes. I think basically we used pretty much the same criteria that we did when we looked at it back at our testimony in 2002. The difference in the result is primarily because of the difference in the economic power environment today, versus a year or so ago, when we looked at it before.

ACALJ NODES: Thank you.

Mr. Wakefield, redirect?

MR. WAKEFIELD: Yes. I'm going to start with that last point.

REDIRECT EXAMINATION

BY MR. WAKEFIELD:

Q. Ms. Diaz Cortez, do you recall that RUCO's position in the PPFAC docket before the joint application was filed did include a concern that the wholesale price of the new Pinnacle West contract was too expensive at the time that that analysis was being performed?

A. Yes.

Q. But today, does RUCO believe that the Pinnacle West contract is too expensive when you analyzed the contract from today's perspective?

A. No.

Q. Ms. Diaz Cortez, would you agree with me that demand-side management programs can have different kinds of benefits for customers?

A. Yes.

Q. Specifically, they can have economic benefits and they can have environmental benefits; is that correct?

A. Yes.

Q. What was RUCO's motivation in proposing DSM programs as a part of this process? Was it the economic benefits that RUCO was seeking or the environmental benefits?

A. The economic. That's the reason we wanted this part to be in the settlement. I think the

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Dittmer

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analysis of the buildout program?

A. (BY MR. DITTMER) Yes.

Q. And the Staff report, or that portion of the Staff report, Pages 6 through 30, represents your testimony in these proceedings?

A. (BY MR. DITTMER) It does.

Q. And could you summarize your portion of the Staff report?

A. (BY MR. DITTMER) Certainly. The major elements of the settlement agreement affecting Citizens' Arizona gas properties, regulated retail rates and books of account include the following major items: First, in August of 2002, Citizens filed a gas base rate application with the ACC, wherein it sought approximately a $21 million annual increase, or an overall average increase of 28.9 percent. Pursuant to the settlement agreement, base gas rates and rates will increase approximately 15.2 million, which equates to an average overall increase of 20.9 percent.

The 20.9 percent increase included in the settlement agreement is not insignificant. However, the Santa Cruz gas division has not had a base rate increase for approximately 15 years, and the northern Arizona gas division has not experienced a base rate increase for approximately eight years.

Further, in Staff's view, the vast majority of the increase in this case is attributable to the hard sunk costs that Citizens has incurred by way of a massive construction program in the form of a buildout.

Other than the controversy surrounding the massive buildout program, the Staff views the Citizens gas filing as a relatively clean rate filing that does not include a lot of exaggerated cost of service claims.

UniSource has negotiated a purchase price that was approximately 30.7 million below the net original depreciated cost of Citizens' Arizona gas properties, included in the December 31, 2001 test year ending rate base, resulting in a negative acquisition adjustment.

The settlement rates pass on all the savings from the negotiated sales price to Arizona retail gas ratepayers in the instant case, as well as in all future rate cases, until such time that negative acquisition adjustment is fully amortized.

I would like to emphasize that the purchase of energy properties below book value or significantly below book value, as is the situation in the instant case, is very unusual.

Further, the company's agreement to pass on the purchase price savings to ratepayers in what is an original cost ratemaking jurisdiction for the most part is also very unusual, and results in significant savings to ratepayers in this and future rate cases.

The settlement rates also incorporated $10 million writedown to gas plant in service attributable to the buildout program. This noted $10 million writedown to gas plant is separate and distinct from and above and beyond the negative acquisition adjustment just described.

Like the negative acquisition adjustment, the $10 million writedown to gas plant in service attributable to the buildout program represents a permanent writedown of the plant that results in savings to future Arizona gas base rate proceedings as well as in the instant case.

If the Citizens gas rate case had proceeded or has to proceed because the transaction before this Commission is rejected, the buildout program issue will prove, in my opinion, to be a highly complex, at least somewhat subjective as to the quantification of an imprudence allowance, and really a pretty colorful issue.

Regarding the complexity and subjectivity surrounding the issues in the case, the Staff's case, if we were to proceed in litigation, would likely include an attempted quantification of the costs of the buildout pipe between what should have been placed in service, if Citizens had vigilantly restudied various elements of the entire program, versus what Citizens actually placed in service.

This will be a complex and somewhat subjective calculation, inasmuch as many pipes constructed serve a dual purpose of reinforcing the system to existing customers for which Citizens did have an obligation to provide service, as well as to service previously unserved territories.

It is likely to be colorful in that you will get to hear Gary Smith and perhaps others from that organization state that they felt that Citizens had made a commitment to proceed with the buildout program, and that indeed, they felt they believed that the Commission was pressuring them, if not an outright mandate to complete the project as was originally presented to the Commission in the 1993, '94 time frame.

An added benefit of the agreement is base rates will not change, gas base rates will not change for a three-year period, barring either emergency condition or material change in cost of service attributable to a select set of events that are beyond the control of UniSource.

Staff views the three-year rate moratorium as an added benefit to ratepayers. The base rate increase is being proposed to be spread evenly among all retail rate classes further. For residential customers, the customer

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Glaser

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VOLUME I
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CITIZENS AND UNISOURCE

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Agreement, I do want to talk a little bit about the settlement process up front since there has been some discussion about the process, and I want to give the record, the ALJ and Commissioner Gleason from UniSource's standpoint how we thought the process went. And I should first note that even before we filed the Settlement Agreement and before we filed actually the Joint Application, we met with several of the parties to explain what was going on and what we intended to file.

But after we filed the Joint Application, we, UniSource, and Staff held several settlement conferences with all the intervenors, and we did that to provide a forum for identified issues that each of the parties felt they wanted to discuss regarding the Joint Application. I believe we did have three all-encompassing meetings where all the parties were not shy about bringing up the issues that they had. So I thought we had a good discussion up front.

Given the number of issues we've talked about today and the number of parties, we, UniSource, offered break-out sessions with all the intervenors in the proceeding. And subsequently, we did obviously meet with Staff. We met with RUCO, we offered to meet with RUCO. As well, we met with Mr. Magruder on two occasions, and we met with representatives from the counties of Santa Cruz and Mohave separately as well while this process was going on to further address their issues. We also met with the City of Nogales one time as well to talk about franchise issues with representatives from the City of Nogales. And to the extent that we could, we tried to address the issues as we were working forward with Staff, but given the multiple aspects of the Settlement Agreement, we tried to work everything in to one agreement as best we could. But obviously, we were focused on the meetings with Staff, and I think we've entered into a fair and reasonable compromise.

Turning to the gas rate case, in our initial filing, in the Joint Application, UniSource supported Citizens' gas rate filing. We did make certain adjustments to reflect some known and measurable changes including introduction of the rate base through our negative acquisition investment. So our original request reduced the revenue requirement increase that Citizens had filed of almost 29 percent to 23 percent in the initial proposal.

After the discussions with Staff, we further agreed to reduce the increase in revenue requirement to roughly 21 percent, and that's by and large agreeing through an adjustment to rate base for the build-out program of almost, a little over $10 million. For ratemaking purposes, as a result, the Settlement Agreement agrees to a fair value rate base of approximately $142 million and a reasonable rate of return, a fair value rate base of 7.49 percent. The parties then agreed to a revenue requirement of approximately $15.2 million. That's the rate side of the gas case.

We also supported the consolidation of the northern and Santa Cruz divisions into a single entity. We did that, we agreed to that, and actually, Citizens had previously filed for that to include standard tariffs to be applied across the two divisions.

As part of the consolidation, though, two low income programs that were only available in the north, Cares and Warm Spirit, will now be expanded to the southern division. The Cares program provides for financial assistance for certain customers on their bills through a cooperative effort with the Arizona Department of Economic Security, DES. DES qualifies customers for the program, and really what it is is a reduction on their bill of a set amount. The Warm Spirit program permits all existing customers to voluntarily contribute to a fund which is established for helping low income customers with bill payment.

Further, in the Settlement Agreement, UniSource agreed to maintain the same level of commitment to gas pipeline safety as currently provided by Citizens. That was something that the Staff was very concerned about. They spoke highly of the gas operations and the gas safety program, and UniSource commits to using the current personnel and to maintaining current safety practices in the gas side.

On the electric side, what the Settlement Agreement does as we talked earlier today is that Citizens' original request to recover past balances of the PPFAC will be foregone by UniSource from retail customers. We've talked a little bit about what the balance is and what it's estimated to be. I will update it here today. With February actuals and estimates through July, we estimate it to be 136.8 million by the close in the summer, by July 28th. As Mr. DeConcini will discuss, we are in discussions with Pinnacle West to see if we can reduce the cost further. Those discussions are the subject, however, of a confidentiality agreement. To the extent we are successful as we have discussed, the

That's an overview of the Settlement Agreement. In my rebuttal testimony, I address response to RUCO's testimony. And as an overview, I should say that we appreciate RUCO's testimony. We also appreciate as I heard Mr. Wakefield state today that RUCO generally supports the Settlement Agreement, and I think that they see the merit in the Settlement Agreement as well. I understand what their proposals go toward, and conceptually I consider them to have, the DSM proposal, consider it to have merit. It's not something, though, that I think should be done today, and let me talk about that.

The DSM proposals that RUCO proposes would bring the expenditure levels of DSM to an extremely high level at a point in time when I think that the Commission is going to be providing all the parties a little bit more guidance on how DSM should be integrated into our portfolios in the future. To increase it now before the Commission has determined how to go forward is premature, and I think we also need to understand that whatever we increase, if we increase DSM funding now, it would have an upward pressure on rates later, and I think that's something that should be discussed in a rate case where we can look at all the other expenses of these properties. I principal negotiator on behalf of UniSource.

Q. And it's fair to say you were present during all the three meetings in January that took place with all the intervenors?

A. (BY MR. GLASER) Yes, I was.

Q. And did you understand or did you witness Staff's intention to negotiate independently with the Joint Applicants, UniSource, Citizens, communicated at that third status meeting?

A. (BY MR. GLASER) Yes, I remember that, and at that point in time, it was very clear that we were going to have a break-out session between UniSource, Citizens, and the Staff. And at the same time, we offered as well to have break-out sessions with the remainder of the intervenors. And as I've said in my summary, UniSource and Citizens did carry forward and offered to meet individually and in fact did meet individually with the rest of the intervenors.

Q. And during that third meeting or at any time during the course of negotiations that you participated in, did any of the other intervenors address any concerns to you or any objections as to how the negotiations, the process was going forward?

A. (BY MR. GLASER) No, nobody objected to the process. And as I said, it was openly communicated and everybody was aware of what was going on, but to answer your question, no, nobody objected to the process.

Q. And is it fair to say that during the meetings in January that there were an abundance of issues that were brought up from all the intervenors, including Staff, in the consolidated cases?

A. (BY MR. GLASER) Certainly. As I said in my summary, nobody was shy in that room or over the phone. There were numerous issues brought to the table which we all, which we tried to address as we've gone forward, but to my recollection, those meetings, nobody either that was in the room or was there telephonically was cut off in any way or restricted. Staff made it abundantly clear to go around the table and ask everybody what they wanted, if they wanted to discuss any of the other issues, and in my opinion, everybody was given ample opportunity to raise what their opinions were on the Joint Application.

Q. And based on your conversations and meetings with the intervenors during the break-out sessions during the time in February and March when these break-out sessions were going on, does it at least appear that the Settlement Agreement tries to capture some of the issues that were brought up by some of the favorably renegotiated, DSM funding would increase another $400,00 per year, is that correct?

A. (BY MR. GLASER) Up to -- yes.

Q. Would you agree with me that RUCO's proposal includes a provision that ElecCo would be permitted to defer the incremental DSM costs for future recovery?

A. (BY MR. GLASER) I agree that is in RUCO's proposal.

Q. And would you agree that under RUCO's proposal, ElecCo would be allowed to accrue interest on those deferrals?

A. (BY MR. GLASER) Yes.

Q. So would you agree with me that with the deferral and accrual of such interest that ElecCo could get full recovery for any additional recovered DSM investment?

A. (BY MR. GLASER) Could, and that is really the issue that I had, Mr. Wakefield, is that it does create the potential upward pressure on rates at a future point in time. But yes, it does allow us the opportunity to come in and ask for recovery.

MR. WAKEFIELD: Those are all my questions.

ACALJ NODES: Thank you.

Mr. Bettwy.

MR. BETTWY: Thank you, Mr. Scott.

A. (BY MR. GLASER) That's correct, but please remember, Ms. Hawn, that as part of the Settlement Agreement, we agreed to a $10 million reduction in rate base related to the gas build-out program, and I think that the Staff had talked about this as well that the negative acquisition adjustment that, because we bought the assets at below book of 30 million can be, you can't maybe tie it directly to the gas build-out program but that there's a total of a $40 million reduction to rate base related to the gas assets. If you assume that I think in rough terms the entire build-out was $75 million or so, you're discussing, you're putting in the rates and customers are enjoying service of $75 million worth of assets for 30-odd million dollars.

Q. Am I correct, am I remembering correctly that in the asset purchase agreement, there was a $10 million, I guess you might call it a signing bonus or closing bonus that was going to be paid to UniSource if this deal closes by a certain date?

A. (BY MR. GLASER) If the deal closes by July 28th, the purchase price will be reduced from 230 million to 220 million.

Q. Is that 10 million related to the 10 million that you were just talking about?

will have another, you will have a chance to give your input into that procedure.

MR. MAGRUDER: Thank you. That's really all my questions, sir.

ACALJ NODES: Okay. Thank you, Mr. Magruder.

EXAMINATION

Q. (BY ACALJ NODES) I've got just a few questions. I think this is probably directed to Mr. Glaser. Regarding the consolidation of the two gas units that is proposed by the Settlement Agreement, what criteria did you use for evaluating whether that consolidation of the systems was reasonable and in the public interest?

A. (BY MR. GLASER) We reviewed Citizens' testimony, and I do believe that the Commission actually requested that that analysis be done. The systems are managed by the same group of folks up in Flagstaff, and it provides common management, common tariffs for customers, per my understanding, and provides for some economies here at the Commission. So what we did is we adopted what Citizens filed in their Application as requesting that consolidation. So we really since tested what was in their testimony.

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Jaress

At: Phoenix, Arizona

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Attorney at Law

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summary.

Q. And basically, you are the, quote-unquote, policy witness and the witness to describe the overall benefit of the settlement agreement?

A. (BY MS. JARESS) Yes.

Q. And could you give your summary of your portion of the Staff report for Your Honor?

A. (BY MS. JARESS) Yes. To briefly reiterate what you heard from Mr. Gellman yesterday, and to summarize the Staff report, Staff believes that the settlement agreement taken as a whole reasonably balances the diverse interests of the customers and the joint applicants.

It facilitates the transfer of the Citizens Arizona gas and electric Certificates of Convenience and Necessity customers and assets to a fit and proper Arizonan utility.

The reduction in the gas rate case revenue requirement, restrictions placed on the post financing, agreements of pipeline safety safeguards, and the rapid movement towards opening the new electric company's service territory to competition are some examples of benefits that will accrue to the customers above and beyond what was offered in the joint application.

Staff urges the Commission to adopt the

settlement agreement because it results in benefits to the customers that in all likelihood are greater than the benefits achievable through traditional processing of the gas rate case, the sale and transfer case, and the electric adjuster case individually.

Staff believes that the settlement agreement is in the public interest, and urges the Commission to adopt it.

Q. Ms. Jaress, just a couple of follow-up questions.

Were you one of the principals from Staff who participated in the negotiation process with the joint applicants, and at a status meeting with the intervenors?

A. (BY MS. JARESS) Yes, I was.

Q. Did any party seem to have any problem with the negotiation process of the procedure as Staff proposed it, either back in January or during the negotiation process?

A. (BY MS. JARESS) I was never made aware that there was a problem.

MR. GELLMAN: Thank you, Ms. Jaress.

BY MR. GELLMAN:

Q. Mr. Dittmer, could you give your name and business address for the record.

A. (BY MR. DITTMER) James R. Dittmer, 740

ACALJ NODES: Any objections?

(No response.)

ACALJ NODES: S-1 is admitted into the record.

MR. GELLMAN: With that, that completes my direct examination. I offer the panel for cross-examination.

ACALJ NODES: Thank you, Mr. Gellman.

Mr. Campbell, do you have questions for the panel.

CROSS-EXAMINATION

BY MR. CAMPBELL:

Q. Ms. Jaress, the settlement agreement includes a provision for bridge financing; isn't that correct?

A. (BY MS. JARESS) Yes, that's correct.

Q. And the settlement agreement also includes a provision for permanent financing; is that correct?

A. (BY MS. JARESS) Yes.

Q. And those two loans are not additive; is that correct?

A. (BY MS. JARESS) That's correct.

Q. In fact, the settlement agreement, under the settlement agreement the proceeds from the permanent loan would be used to pay off the bridge loan; is that correct?

A. (BY MS. JARESS) Yes.

Q. Let's talk for a minute about the revolving credit line, $50 million. The settlement agreement calls for a revolving credit line; correct?
A. (BY MS. JARESS) Yes.
Q. And is it typical that public service corporations in Arizona would have a revolving credit line?
A. (BY MS. JARESS) Yes.
Q. And is it also accurate to say that energy companies such as the companies in this proceeding, that their cash flow varies seasonally?
A. (BY MS. JARESS) Yes.
Q. And is it also true that one of the primary reasons for a credit line for an energy company is to address the seasonal cash flow?
A. (BY MS. JARESS) Yes.
Q. Let's talk about the TEP loan for just a minute. The settlement agreement contemplates that TEP may loan up to $50 million to UniSource to provide flexibility in the financing of this transaction; is that correct?
A. (BY MS. JARESS) Yes.
Q. And that loan will be secured by all of the stock of the new companies or their holding company; is that correct?

1.825 cents. The 1.825 cents is about 20 percent, 22 percent increase. If you had that and you added the recovery of the amounts under the old contract, my calculations were it would be about a total of 40 some percent increase.

MR. MEEK: I'm on the same page. My only point is that I'm trying to help Mr. White understand what the differences are, where we were a couple of years ago, and where we are today. I think that's all.

ACALJ NODES: Thank you, Mr. Meek.

Mr. Wakefield.

CROSS-EXAMINATION

BY MR. WAKEFIELD:

Q. Good morning, Ms. Jaress. I think you may be the one to answer all my questions; if not, toss the question off to whoever is the appropriate person.

Ms. Jaress, the settlement agreement that's the subject of this hearing resulted from negotiations that took place between Staff and the joint applicants; is that correct?

A. (BY MS. JARESS) That's correct.

Q. And in those settlement negotiations, did Staff raise the issue of any additional demand-side management programs that might be a mechanism to allow

A. (BY MS. JARESS) Yes.

Q. Ms. Jaress, absent this settlement agreement, if Citizens were to renegotiate the Pinnacle West contract, any savings of that renegotiation would flow through 100 percent to customers; correct?

A. (BY MS. JARESS) That is correct, but I think you need to keep in mind two things. First, the joint application offered to split 50/50 those savings, and through negotiations, the customers result with a larger percentage of those savings. Now, when it comes to renegotiating a power contract, the company would, I believe, would be likely to be even more motivated to bargain harder, get a better contract if they retain part of the savings.

Q. So the reason that Staff concluded their settlement negotiations while still allowing the company to retain 40 percent of those savings was because you felt it was necessary as an incentive for the company to renegotiate the Pinn West contract?

A. (BY MS. JARESS) The reason -- it's difficult to look at these issues alone. That is a reason for having it in there. The reason it's in there has to do with the entire settlement agreement and a give and take.

Q. Fair enough.

Ms. Jaress, has Staff done any analysis as to provided in the procedural order. But we were not denied any opportunity to be involved.

ACALJ NODES: Thanks. Can you hand the microphone back to Mr. White, let's see if we can continue with cross-examination.

MR. WHITE: Now I can see that I shouldn't try to clarify that. Thank you very much, Your Honor.

BY MR. WHITE:

Q. Ms. Jaress, in response to a question from Mr. Meek, when he asked you to go back and give your estimate of the rates as they would have been, you came up with a 40 to 45 percent increase figure; is that correct?

A. (BY MS. JARESS) Yes.

Q. Is that taken into account, Ms. Smith's recommendation that $70 million of the old contract amount be put over until it had been determined by somebody to be a valid amount to pass through?

A. (BY MS. JARESS) No, that was the entire underrecovery.

Q. And it also included the new contract amount, too?

A. (BY MS. JARESS) Yes.

Q. So if you take out the new contract amount for a moment, and Ms. Smith's recommendation that 70 million be looked at by some third party to determine its validity --

ACALJ NODES: Wait a minute. I'm not sure that that was her recommendation. She may want to jump in here and clarify it. That isn't what I understood her recommendation to be. If it is, please clarify.

MS. JARESS: No, all that 40, 42 percent was the worst-case scenario.

BY MR. WHITE:

Q. Okay, that's what I wanted to clarify.

A. (BY MS. JARESS) If the Commission approved the recovery of the old contract and the new contract together.

Q. But if it didn't, that's the worst-case scenario, and the best-case scenario would have been what? Either of you.

A. (BY MS. SMITH) I mentioned earlier that I believe that -- I computed these exact numbers, but I think that the recoveries would have been about 40 million. And on Page 41, the numbers that are called best are the percentage increase that would have resulted from what I thought was the best case, which was that FERC agreed to deny APS and therefore return to Citizens the entire $70 million. And our disallowance of $7 million was by the Commission, and that the Commission disallowed the underrecovery under the new contract, that would have provision relating to franchises in the settlement agreement, that we have a right to explore their thinking about their language in that agreement.

ACALJ NODES: We'll take judicial notice of the settlement agreement and the Commission's decision approving that settlement agreement.

The witness can answer to the extent that she is able to answer personal knowledge of that agreement.

MR. HOLUB: I understand.

BY MR. HOLUB:

Q. Ms. Jaress, did you, in your negotiations with UniSource to put the settlement agreement together, consider this prior decision of the Commission and that issue when you came up with your language for the franchise section?

A. (BY MS. JARESS) When we came up with our language for the franchise section, we adopted language that we almost without exception, that I can remember, always used. The franchise issue is generally between the municipality or the county and the company.

We have what we recommend as the requirement that the franchise be filed in 365 days.

Q. Is it not a mandate of this state that any utility doing business in a city have a franchise?

MR. GELLMAN: Your Honor, beyond the scope of

BY MR. HOLUB:
Q. Is it the Commission's normal pattern to check on franchises when CC&Ns are being transferred?
A. (BY MS. JARESS) What do you mean check?
Q. You have a checklist when you go through transfers of CC&Ns, don't you, issues?
A. (BY MS. JARESS) I assume we do, yes. If it's not written down it's certainly what we do when there are certain things that we look at.
Q. What's the Commission's position if a company doesn't have a franchise, say in the 365 days, or your Staff's position? Does that mean we have to file another case here?
A. (BY MS. JARESS) Well, that would normally mean that something would get filed. Either Staff would do an order to show cause, the company would file for an extension, something would happen, yes.
Q. Do you remember in the teleconference that I specifically advised you of, in this fact situation, of an order and a default of the order, in fact that my city had a huge problem with this?
MR. GELLMAN: Your Honor, again, continuing objection. The franchise issue involving whatever docket Mr. Holub cited is beyond the scope of this proceeding.
MR. HOLUB: Your Honor, it's not. They have

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Larson

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REPORTER'S TRANSCRIPT OF PROCEEDINGS

VOLUME I
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Prepared for:

CITIZENS AND UNISOURCE

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I am testifying on matters relating to the acquisition and financing plan specified in the Settlement Agreement between the Joint Applicants and the Arizona Corporate Commission Staff as well as certain financial safeguards in the settlement related to Tucson Electric Power and the new utility companies to be formed as a result of the acquisition. Finally, I am testifying in support of the rate of return specified in the settlement for the use in the Arizona gas rate filing.

Let me first talk about the financing plan. The acquisition financing plan described in the settlement provides UniSource with the flexibility needed to complete the acquisition in a timely and cost-effective manner. This plan contemplates an increase of debt securities by using assets of the company to be established under UniSource or by intermediate holding company that would own and finance these new companies. The new companies would also be authorized to issue common stock to UniSource or the holding company to reflect the equity capital invested by UniSource in the new companies.

The combination of debt issuance proceeds which we requested up to $175 million and the equity investment by UniSource which we estimate between 75 and $125 million should be sufficient to fund the purchase price and the initial working capital needs of the new companies.

Assuming an all-in purchase price of $230 million, we estimate today the debt of approximately $140 million and UniSource equity investment of $90 million. The specifics of this plan which are outlined in the Financing Plan which is outlined in Appendix 8 of the agreement also provide an option for the holding company or the new companies to obtain interim bridge financing for the acquisition.

I need to note that the short-term bridge financing is not additive to the $230 million funding I described earlier. Bridge financing is an alternative, a substitute for all or a portion of the long-term financing that may not be available under reasonable terms at the time we close the transaction. The bridge financing is a backstop that gives us flexibility and more confidence that we can complete the transaction on a timely basis under the timeline we've discussed.

In light of the significant long-term benefits to be realized by customers as a result of the acquisition, approval of the financing plan perspective of maintaining the right balance of equity and debt when financing this acquisition?

A. (BY MR. LARSON) Yes, that's correct.

Q. And from a financial perspective, the TEP loan would be considered equity for that perspective?

A. (BY MR. LARSON) Yes, the design that Tucson Electric Power would lend the money to UniSource, and UniSource would use those funds along with other funds that it has or would have and contribute it into the new operating companies related to Citizens' assets.

Q. And it's important from UniSource's perspective to have this loan included as part of the equation such that the right combination of debt equity financing is preserved?

A. (BY MR. LARSON) That is a component of it. Also another component is to make sure we have sufficient tools to complete the acquisition in late July.

Q. And even though TEP is part of this Application, and hopefully if the settlement is approved by the Commission, is part of the equation, will there be any I guess decreased chance of or impact on TEP being able to perform its operations and maintenance if this TEP loan is actually done?

A. (BY MR. LARSON) We don't believe it would impact Tucson Electric Power, and that is a key issue that we looked at. And I think that the rating agencies have come away with a similar conclusion that it will not be adverse to Tucson Electric Power Company.

Q. So there won't be any problem with "fixing things" even if the TEP loan does go to UniSource?

A. (BY MR. LARSON) I'm not sure what you mean by fixing things.

Q. If something were to break, TEP would be able to go fix it and there wouldn't be a problem because of this loan?

A. (BY MR. LARSON) It should not be a problem.

Q. And could you talk a little bit about the importance of the new companies acquiring I think what you called investment grade status?

A. (BY MR. LARSON) Yes. We structured this that we anticipate getting investment grade ratings from the credit rating agencies, and it will be critical in terms of reducing the cost of capital, in particular on the debt side. An investment grade we anticipate would probably be a triple B flat or a triple B minus investment grade rating which is at the bottom end of an investment grade rating, but the critical point is it's better than a non-investment

A. (BY MR. LARSON) Yes, it will.
Q. And that's because there's a minimized combination of what's known as financial risk and in combination with a less expensive cost of capital?
A. (BY MR. LARSON) Yes, that's right. There's a trade-off between the cost of debt and the cost of equity. Equity is typically going to cost more than debt cost would be. And so in the perfect world, I guess, in theory at least, the lowest cost you could have is if you did all debt financing, but you couldn't get all debt financing because the lenders would not be willing to take that risk that there's no equity cushion to protect them in the event there are surprises at that operating company. So typically, what you see in the electric utility and gas industries is an equity ratio somewhere between 35 to maybe 45 percent, and that's why we're essentially targeted in between that at 40 percent.
Q. And so by having the flexibility to finance this transaction or the acquisition of Citizens' electric and gas assets, you will have a better chance of getting investment grade status for both the ElecCo and the GasCo?
A. (BY MR. LARSON) Yes, I believe we will.
Q. And that will result in lower cost of capital

lease obligations, in excess of $300 million. We are continuing, we still have that same intent. We're targeting from 30 to 50 million on an annual basis to deleverage the firm, and we believe we have more than sufficient cash flows, cash balances to fund a $50 million, up to a $50 million loan to the UniSource parent.

And so one, there shouldn't be any real cash concerns for Tucson Electric Power Company, and I referenced earlier that the rating agencies have essentially come to the same conclusion. They haven't made a final decision, I have to caution you on that, but the rating agencies I think view the proposed settlement with the ACC Staff we have reached regarding the Citizens assets including the loan component as not an adverse impact to Tucson Electric Power Company. We do not envision the rates of TEP changing.

So beyond just a cash flow impact for Tucson Electric Power Company which I think is small given the cash flows of that company, if you look at the, some of the benefits for Tucson Electric Power Company, TEP currently on a short-term basis is probably earning one and a half percent, 2.25 percent. This loan we will be lending to UniSource will be company for Citizens, again, we are assuming, if we end up with a $230 million acquisition price, all-in price, I would estimate the amount of debt, longer term debt would be 140 to $150 million, and as part of my testimony, we estimate the cost of that debt would be all-in 7.75 percent. In addition to that, that's kind of the funding for the acquisition.

We've also requested as part of this Application ability to have a bank line, a revolver available to just deal with seasonal fluctuations in cash flow of the businesses, but that would not immediately be funded.

COM. GLEASON: And that's 190, right?

MR. LARSON: Let's say $150 million permanent or longer term debt, and separately just to deal with the working capital needs, we would have a bank facility that we could draw down on for seasonal periods, maybe just for one month, and then once the cash flows of the business improve, simply pay down the revolver. So it's more of a short-term financing, the revolver component.

COM. GLEASON: But I'm looking at part of the Staff Report here on page 44. The debt issuances are limited to 175,000, 175 million. That's also I think someplace in your deposition here.

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Mason

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Finally, in accordance with the Commission's standard filing requirements, I sponsor schedules showing the cost of long-term debt and preferred stock. I present projections and forecasts of financial statements for 2002, and of construction expenditures for years 2002 through 2004.

Based on the testimony summarized above, the AGD is requesting an overall revenue increase of approximately $21 million. That revenue increase is premised on a rate base of approximately $150 million, total operating expenses of approximately $30 million and an overall rate of return of 8.85 percent and an 11 percent cost of equity.

Mr. Apuzzo, Citizens' director of tax and actuarial compliance, sponsored testimony relating to calculated deferred income taxes, and the differences between the books kept for regulatory purposes, and the books kept for tax purposes.

The ADIT served to reduce the Arizona gas division's rate base in Citizens' filing. As of the date of the acquisition of Citizens' Arizona gas assets, the deferred taxes for those properties are eliminated.

Mr. Apuzzo also testified to various tax expenses included in the filing, and amounts related to tax refunds associated with pre-tax year items that have

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McCarthy

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MR. GELLMAN: Thank you. No further questions.

ACALJ NODES: Thank you.

Mr. Meek.

CROSS-EXAMINATION

BY MR. MEEK:

Q. Good afternoon, gentlemen. Mr. McCarthy, I have three or four pretty short questions for you. If this transaction fails, will Citizens pursue recovery of the PPFAC underrecovery at its current amount, plus any accumulated amounts?

A. (BY MR. McCARTHY) Yes, we will.

Q. Will you do that aggressively?

A. (BY MR. McCARTHY) Yes, we will.

Q. If this transaction should fail, would Citizens commence to litigate its gas rate case based on the original revenue deficiency that was filed in that case?

A. (BY MR. McCARTHY) Yes, we will.

Q. And that amount will be, as I recall, what, $28 million or so, $21 million?

A. (BY MR. McCARTHY) 21. Yes, we will.

Q. If this transaction were to fail, would Citizens voluntarily reduce its gas rate base by

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Meek

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REPORTER'S TRANSCRIPT OF PROCEEDINGS

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shareholders and Citizens Communications Company have to give away more than 250 million in assets in order to make this transaction happen. Having said that, my testimony points out that Citizens' sacrifice produces a very good deal for the ratepayers of Citizens' gas and electric divisions.

With more than $150 million in direct consumer benefits, those benefits accrue from the forfeiture of a PPFAC balance through next July, reduction of gas revenue requirement in the rate case, and permanent elimination of $10 million in the gas system rate base. In addition, the settlement agreement contains adequate buffering and risk mitigation to protect Tucson Electric Power Company's ratepayers from any unforeseen consequences.

This transaction is clearly in the public interest. In addition to the financial benefits to the consumers, there is no question that Unisource Energy Corporation is a fit and proper entity to acquire Citizens' gas and electric assets.

Another factor is that Citizens clearly wants to exit the gas and electric businesses, and this agreement allows them to do so.

Now, I'd like to add an observation on some of the assertions that have been made by the intervenors from Mohave and Santa Cruz Counties. I don't expect anyone to

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Pignatelli

At: Phoenix, Arizona

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VOLUME I
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transaction, and the citizens in those counties can enjoy continuous dealing with Citizens Utility.

That's all my prepared remarks.

MR. CAMPBELL: Mr. Pignatelli is available for cross-examination.

ACALJ NODES: Thank you.

Mr. Gellman, do you have any questions for the witness?

MR. GELLMAN: Your Honor, just a couple questions.

CROSS-EXAMINATION

Q. (BY MR. GELLMAN) Good morning, Mr. Pignatelli.

A. Good morning, sir.

Q. From your perspective and from UniSource's perspective, how important was it to have all of the three cases that were before this proceeding today to be resolved, three cases being the PPFAC case, the general gas rate filing, and the Joint Application?

A. We have to resolve it all at this time. UniSource will not accept ongoing liability or uncertainty in either rates or recovery of past charges or reasonableness of past contracts. We want to put all of that behind the state and move forward. We will not close the transaction unless all of this is resolved at this time.

Q. And just to follow up on that, was it important to have a process of negotiation by which a Settlement Agreement could be approved by this Commission such that the anticipated date of closing, July 28th of this year, could be reached?

A. I think it was important not only for the timing to bring to closure all of these, but factually just the pure volume and the technicalities and the extensive testimony that would be required to individually hear these, we felt that settlement was the proper way to do it, especially considering that we were going to waive complete recovery of past PPFAC that should take that out of issue. We just felt that the litigation which would be out there would be continuous, ongoing, and end up in making a transaction which could never be consummated. We needed rapidity in understanding of the facts, and Staff and the settlement I think did a great job in representing the consumer in this, but we needed to tie it all together so that we could go out and finance this in a timely manner and not leave all these issues hanging over everyone interminably.

up?

A. We have three transactions, correct. We don't have a financial obligation with Springerville.

Q. Okay.

A. So we have two transactions. The transmission line is down the road. I don't see the transmission line being built before 2004, 2005, simply because of permitting. So I'm focusing on this transaction right now, the Citizens transaction.

Q. Okay. You know the Commission Order for the transmission line says it should be installed by the end of this year, and there's a $30,000 a month fine. Are you familiar with those penalty clauses in that Order? Are you familiar with that portion of the Order?

A. You can discuss that with Mr. Glaser, but we have already indicated to the Commission that that cannot be met because of conditions outside of our power, and we will be, as soon as we can make a firm determination of when we expect final permitting to be completed and the length of time necessary to build a line that we will come to the Commission and ask for a change in that Order.

Q. In some of the discovery, I found out that the present transmission line and the new transmission

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Smith, L.

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service.

This will be a complex and somewhat subjective calculation, inasmuch as many pipes constructed serve a dual purpose of reinforcing the system to existing customers for which Citizens did have an obligation to provide service, as well as to service previously unserved territories.

It is likely to be colorful in that you will get to hear Gary Smith and perhaps others from that organization state that they felt that Citizens had made a commitment to proceed with the buildout program, and that indeed, they felt they believed that the Commission was pressuring them, if not an outright mandate to complete the project as was originally presented to the Commission in the 1993, '94 time frame.

An added benefit of the agreement is base rates will not change, gas base rates will not change for a three-year period, barring either emergency condition or material change in cost of service attributable to a select set of events that are beyond the control of UniSource.

Staff views the three-year rate moratorium as an added benefit to ratepayers. The base rate increase is being proposed to be spread evenly among all retail rate classes further. For residential customers, the customer

The dollars that I mentioned, the 135 million do not include any carrying costs from the past on a going-forward basis. This could have been another $18 million in carrying costs.

And I would like to mention that even if we had had a very favorable Commission decision in the adjuster case, and subsequently a favorable decision on the part of the FERC, the Federal Energy Regulatory Commission, there still would have been some recovery of these dollars. My estimate is, at a very minimum, $40 million, and quite possibly much higher than that.

The second thing that's beneficial, the second group of things have to do with base rates. The rate base has been reduced by approximately one-half, which is a significant concession, and it will mean that rates will be lower into the long-term for electric customers.

The next point is that the company has agreed that they will not file a rate increase for three years. And I don't see Mr. Pignatelli here, but I hate to tell him there is not going to be an increase in electric rates for four years, because if the company files in three years, there's a 12-month period before that becomes an increase.

Then also associated with rates, power costs will be fixed for the next five years. There will be an increase at this time, but there will be no further increase for five years.

Now, that brings us to the painful part of this proceeding, is that the PPFAC will increase by, you've heard again many times, 1.825 cents per kilowatt hour, although I would note that the PPFAC has not really increased since 1995, so customers have had stable power costs for a long time.

And I also note, and I think this is crucial to this proceeding, is that currently customers are paying less than the cost of the power they are using. They're paying less than the cost they're using; they're paying less than the cost of almost any alternative source of power that would be available.

We have to keep in mind in this case that Citizens does not own any generation, that means they have to buy from someone else, and this PPFAC, as a result, comes from a FERC approved contract, which I will discuss later.

There is some potential for rate relief going forward, and that includes the renegotiation which you've heard discussed, which could lead to some decrease in the PPFAC. In addition, the coordination of the Santa Cruz division with TEP may in the long-term lead to some reduction in rates, but it also should increase prices, not shaped prices -- let's talk in megawatt hours. Then instead of talking about 4.8 cents a kilowatt hour, we'll say $48 a megawatt hour. Same thing. He started with a base price of $48 a megawatt hour. To that you're going to have to follow load. Our estimates in New England PGM easily costs you $6 a megawatt hour. So in addition you're going to have to pay for transmission and ancillary services, that's going to cost about $5 a megawatt hour. That brings us up to $59 dollars a megawatt hour. This is without the risk premium that I mentioned. It is my belief that the risk premium is going to run about 10 percent.

Now, I had originally done some analysis based on recent spot prices. You may not be aware, but one of the things that's happened as the electric industry has gotten more competitive, it's gotten harder to find data. A lot of data becomes valuable so it's not publicly available. So based on spot prices from Palo Verde, which are available, over the last year, I think I would have started with a base that might have been $42.

Now, when we went through that same exercise and we add to the $42 flat power costs, load following transmission ancillary services and a risk premium, we come up to $58. So my analysis suggests that this contract is quite reasonable. It definitely would pass

A. (BY MS. SMITH) Well, I have testified from the standpoint of consumer advocates many times, and I know a 22 percent increase is a concern; it is a real concern to customers. But I don't think it's outrageous, and I think that it's quite justified.

And I think that the perspective that we need to put it in, it's very hard for customers to put it in, is that they have essentially had no increase in power costs from 1995 through 2003. And once they get this increase, there will be no further increase in power costs for the next five years. In addition to that, these customers had been paying the same base rates from 1997 to 2003, and they will continue paying those same base rates through 2007.

So it's a big jump, but it would not have been surprising, in fact it's surprising that they did not experience increases several years ago or maybe several increases, so that the total position that they're in I think is not surprising when viewed in the historical perspective.

MR. GELLMAN: Thank you, Ms. Smith.

BY MR. GELLMAN:

Q. Mr. Thornton, could you please give your name and business address for the record.

A. (BY MR. THORNTON) Good morning. My full name led to my comments leading to best.

Q. Just so we put that in context of the 22 percent increase that's under the settlement, what would that increase have been?

A. (BY MS. SMITH) It would have been about 5 percent higher. You'll see it's different for each class, something like 27 to 28 percent.

Q. So the comparison of this new contract, looking at even the best-case scenario that you could expect under the old contract, would have been a 27 percent increase as opposed to the 22 percent increase we see now?

A. (BY MS. SMITH) Yes, that's correct.

MR. WHITE: That's the question I've been searching for. Thank you so much, Ms. Smith. And I have no further questions.

ACALJ NODES: Thank you.

Mr. Holub.

MR. HOLUB: Thank you.

CROSS-EXAMINATION

BY MR. HOLUB:

Q. Ms. Jaress, could you first explain the benefit of the competition, opening up this area to retail competition?

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Thornton

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attached. First is the term, which is limited to four years.

Second, the interest rate UniSource pays is the same noninvestment grade rate used in the recent APS financing case, that is to say 383 basis points above the equivalent U.S. treasury.

The third is the dividend payment restrictions, which were approved for TEP and imposed on the new companies.

Fourth, 264 basis points of the interest rate paid to TEP will be deferred and used to reduce TEP's customers' rates in the future. I estimate the balance of this deferred credit account to be about $6 million.

Finally, I'd like to address Commissioner Gleason's letter of April 24th. He raised some excellent concerns, which Staff shares.

The loan from TEP to UniSource provides UniSource the needed financial flexibility to complete this transaction, and Staff's concern with it led to hard negotiations to limit its risks to TEP.

First I interpret his concerns to generally show a sensitivity to utility/affiliate relationships. And it's a pleasure to serve in a jurisdiction in which these relationships are heartily scrutinized.

In particular, I viewed the letter, showed the concern over the proposed loan from TEP to UniSource. Staff's position is that a loan from a regulated utility to an affiliate should be approved only under extraordinary and unique circumstances. The extent of the rate concessions, the operational transfer of Citizens' electric and gas operations to a local utility, and other benefits enumerated in the Staff report offer such extraordinary circumstances.

Staff has tried diligently to establish new conditions or improve existing conditions to protect TEP's ratepayers from harm. Commissioner Gleason's first question regards policy implications of a regulated utility's loaning money to its parent. The policy implications are broad, and it should be taken seriously.

In this case, however, the proceeds of the loan are going to eventually fund an investment in regulated utility operations. Staff feels that the policy of locations would be more serious if the proceeds were to be used for nonregulated and nonutility purposes.

Commissioner Gleason's second question regards the transaction's benefits to TEP's ratepayers. If TEP does make the $50 million loan to UniSource, then TEP customers should potentially reap a $6 million gain to offset future rates. The gain is through a deferral of part of the interest payment that UniSource pays to TEP one of the metrics uses assets as part of the calculation.

Q. Let's not pursue it any further.

A. (BY MR. THORNTON) I can't think of one offhand, I'm sorry.

Q. Thank you.

The other thing, now that we've had some discussions of whether these debts are additive, as I read the settlement, the settlement reads that they're additive. In other words, would Staff have any objection if we change that to not to be an additive nature, but as it's been testified here, to be a simple verbal exchange so that they're not perceived as additive? Is that a problem?

A. (BY MR. THORNTON) The one element that is additive, I would add, before Ms. Jaress speaks, is the revolving credit agreement is in addition to the long-term financing. Because what you need is either bridge financing or long-term financing to get the assets in place, and some capital for any needed additions up front. That's long-term.

The revolving credit agreement is on the side, and that's simply to match your cash flows. So that part is additive, the revolving credit agreement.

A. (BY MS. JARESS) Commissioner, if the language that you're looking for only clarifies what we agree is

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White

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the testimony, that I thought the testimony was that you were consulted and given an opportunity, but you were also individually, perhaps.

MR. WHITE: Actually, we were not only consulted and given the opportunity, the original settlement agreement that was proffered to us to review had in parentheses "and other parties that agree to the proposed settlement." In other words, it was proposed that the intervenors be signatories to the settlement if, during the course of those negotiations, they agreed to it, and those parties, to the extent -- we didn't, anyhow, so I never saw it the least bit askance that we weren't signatory parties to it. We didn't agree to it.

The implication now on the record is that somehow we weren't offered that signatory status, and that's the only reason I was offering it.

ACALJ NODES: I didn't understand that to be the case, but if that was what you understood, feel free to clarify the record on that.

MR. HOLUB: Your Honor, I understood that same thing. I've got the same document and I have the same problem with this process.

ACALJ NODES: Can you talk into the microphone, Mr. Holub.

MR. HOLUB: Yes, Your Honor. I have the same

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DIRECT TESTIMONY OF JAMES S. PIGNATELLI
UNISOURCE ENERGY CORPORATION

DECEMBER 18, 2002

Q. Please state your name and business address.

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

Q. What is your position with UniSource Energy Company ("UniSource")?

A. I am Chairman of the Board, President and Chief Executive Officer. I also hold the same positions with Tucson Electric Power Company ("TEP").

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

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

I have worked in the utility industry since my college days, with the exception of two years when I was in the military during the Vietnam War. I served in various positions at San Diego Gas & Electric Company and Southern California Edison Company in accounting, economics, business planning and strategic planning. Prior to joining UniSource, I served as the Chief Executive Officer of Mission Energy, which was the largest independent power producer in the world at the time.

Q. Please generally describe UniSource's businesses?

A. UniSource Energy Corporation is the parent company of TEP, Millennium Energy Holdings, Inc. ("Millennium"), and UniSource Energy Development Company ("UED"). TEP, an Arizona public service corporation, is the principal subsidiary of UniSource and serves approximately 360,000 customers in southern Arizona. Millennium is the parent company of certain unregulated energy businesses, including:

1. Global Solar Energy, Inc., which develops and manufactures flexible thin-film photovoltaic material that converts sunlight to electricity. Its target markets include military, aerospace and commercial applications.
2. Infinite Power Solutions, Inc., which is developing micro-miniature, thin-film, solid state rechargeable batteries for use in medical implants, computer components and radio frequency identification tags.
3. Southwest Energy Solutions, Inc. (SES), which is a regional electric contractor and provider of energy support and construction services to electric customers.

UED will be developing two new 400 MW generation units at the existing Springerville Generation Site.

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

A. My testimony will describe the benefits of this transaction and why it is in the public interest. I urge the Arizona Corporation Commission to approve the transaction for the following reasons:

- Significant gas and electric facilities, operations and customers in both northern and southern Arizona will now be the responsibility of UniSource, an Arizona-based company that is well known, accessible and held in high regard by the community. UniSource is experienced in providing quality utility service to Arizona citizens.

- UniSource will retain substantially all of the Arizona-based employees of Citizens, which will minimize any negative economic impact of this transaction.
- TEP's service and financial condition will not be impaired by this transaction.
- This transaction will facilitate the resolution of the long-standing purchased power and fuel adjustment clause case ("PPFAC Case").
- Although a gas rate increase is necessary due to substantial new investment in facilities, this transaction will result in a reduction in the almost 29% increase proposed by Citizens.

My testimony will discuss the transactions described in the Asset Purchase Agreement between Citizens and UniSource dated October 29, 2002, relating to the purchase of Citizens' electric utility business in Arizona ("Electric Agreement") and the Asset Purchase Agreement dated October 29, 2002, relating to Citizens' gas utility business in Arizona ("Gas Agreement"). My testimony will describe UniSource's reasons for entering the Electric Agreement and the Gas Agreement and the benefits that UniSource will provide in operating these electric and gas businesses. Next, I will briefly describe the financing of the transaction. Finally, I will describe UniSource's position with respect to Citizens' pending gas rate case, Docket No. G-01032A-02-0598, ("Gas Rate Case") and the PPFAC Case, Docket No. E-01032C-00-0751.

Q. Have you reviewed the Joint Application filed by UniSource, TEP and Citizens?
A. Yes.

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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.

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.

	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

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DIRECT TESTIMONY OF KEVIN LARSON
UNISOURCE ENERGY CORPORATION

DECEMBER 18, 2002

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Kevin P. Larson. My business address is One South Church Avenue, Tucson, Arizona 85701.

Q. What is your position with UniSource Energy Corporation ("UniSource" or "Company")?

A. I am Vice President, Chief Financial Officer and Treasurer of UniSource. I also hold the same positions with Tucson Electric Power Company ("TEP").

Q. Please summarize your professional experience and education.

A. I joined TEP in 1985 as a financial analyst, and in 1991, I became Assistant Treasurer. In 1994, I was elected Treasurer, and in 1997, I became a Vice President at TEP. I became Vice President, Chief Financial Officer and Treasurer of TEP and UniSource in October 2000. I report directly to Mr. James Pignatelli, the Company's President and Chief Executive Officer.

My educational background includes a Bachelor of Science degree in Economics from the University of Minnesota, Minneapolis, and graduate work in finance at the University of Arizona. I am also a Chartered Financial Analyst ("CFA").

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is twofold. First, I will provide additional information in support of the financing plan described in Section V of the Joint Application filed by UniSource and Citizens Communications Company ("Citizens") for the sale and transfer of certain electric and gas assets to UniSource ("Joint Application"). Second, I will provide a cost of capital estimate for use in the amended general rate case for Citizens' Arizona Gas Division ("Gas Rate Case").

II. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. Please summarize your findings and conclusions with respect to the financing plan described in the Joint Application.

A. The financing plan contained in the Joint Application provides UniSource with the flexibility needed to fund the acquisition in a timely and cost efficient manner. Due to the potential for unanticipated changes in the capital markets, and the timeframe required for closing the purchase transaction, the flexibility requested in the Joint Application is both reasonable and necessary. The ability to fund the debt portion requested rate of return. First, I recommend using a capital structure that better reflects the financing plan described in the Joint Application. Second, I recommend using a cost of debt that reflects the anticipated cost of debt to the New Utility Companies.

Q. What capital structure are you recommending for the Gas Rate Case?

A. UniSource anticipates capitalizing the New Utility Companies with a common equity investment in the range of 30-50% of total capital. As such, I recommend using the midpoint of this range for rate setting purposes. For purposes of calculating the weighted average cost of capital, the capital structure would therefore consist of 40% common equity and 60% long-term debt.

Q. What cost of debt are you recommending for the Gas Rate Case?

A. As stated above in Section III of my testimony, the Company's preferred alternative is to issue corporate bonds either through an intermediate holding company or directly by the New Utility Companies. These bonds may be issued in several different series, each having its own maturity date and interest rate. Assuming the bonds are issued with low investment grade credit ratings (Baa or BBB), and that bond market conditions do not change materially between now and the issuance date, a cost of debt in the range of 7% to 8% should be attainable by the New Utility Companies. This estimate falls within the range of debt costs realized by other BBB rated utilities during the second half of 2002. BBB rated utility bonds with maturities of seven to ten years have been issued over this time period at an annual cost (or yield to maturity) of between 5.6% and 8.1%. Comparably rated bonds with longer maturities (15 to 30 years) have also been issued at an annual cost of between 6.8% and 7.6%. Although the estimated cost of debt for the New Utility Companies is at the high end of each range, this is reasonable to expect in light of the relatively small size of the New Utility Company issuances, as well as the limited track record for these new companies. Additionally, as discussed previously in my testimony, there is no guarantee that the bonds will actually achieve an investment grade credit rating. Speculative grade issuers have had a very difficult time issuing new bonds in recent months, and when successful, these issuers have had to pay a significantly higher price for the capital relative to investment grade issuers. Based on what is known today, my best estimate for the cost of debt to be issued by the New Utility Companies is 7.5%. After factoring in the amortization of debt issuance costs, as well as the costs of arranging and maintaining a revolving credit facility, I recommend using a cost of debt of 7.75% for rate setting purposes.

Q. You previously mentioned that the cost of equity capital to the New Utility Companies will likely be higher than the 11% return on equity requested by Citizens. What is the basis for your statement?

A. Citizens requested return on equity is based on the low end of a range estimated by witness Robert G. Rosenberg. This range was based on the cost of equity capital for a comparable group of gas distribution companies. Most of the companies in this group have credit ratings higher than Baa/BBB. Additionally, the group has a median equity to capital ratio of 50%. Since the New Utility Companies are expected to have lower credit ratings and slightly higher debt leverage relative to Mr. Rosenberg's comparable group, the cost of equity capital for the New Utility Companies will likely be higher than the 11% requested by Citizens. However, for purposes of setting rates in this proceeding, UniSource is willing to accept the 11% return on equity requested by Citizens.

Q. Based on the mix of capital and component costs of capital you have recommended, what is the overall weighted-average cost of capital you are recommending?

A. The overall cost of capital I recommend using in the Gas Rate Case is 9.05%, as summarized in the following table:

	% of Total Capital	Cost Rate	Weighted Cost
Debt	60.0%	7.75%	4.65%
Common Equity	40.0%	11.00%	4.40%
Total	100.0%		9.05%

Q. Does this conclude your testimony?

A. Yes, it does.

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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 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.

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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".

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?

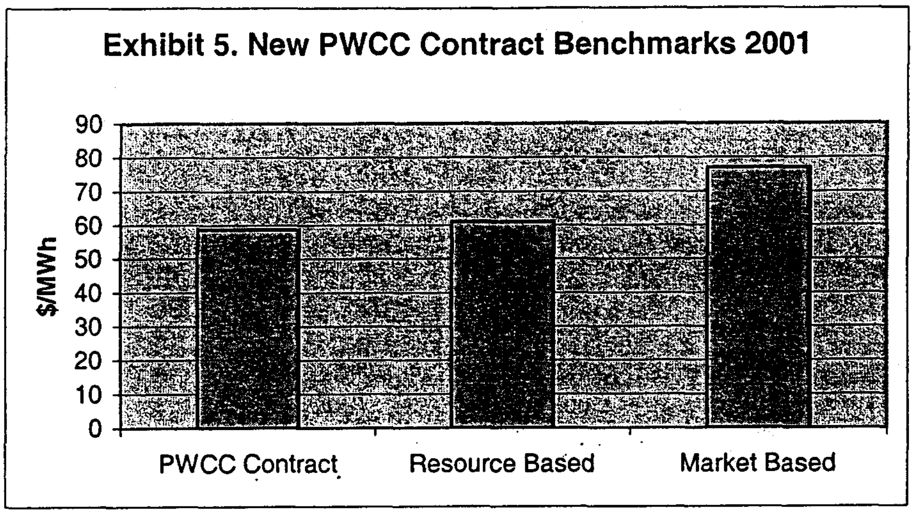
A. The resource-based analysis included the assumption that the capacity (plant) would be immediately available which would not have been feasible at the time. Due to the necessary time to permit and build a new plant, the California contracts reflected market-based prices for the first 2 years which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



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.

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BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER
JEFF HATCH-MILLER
COMMISSIONER
MIKE GLEASON
COMMISSIONER

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 ENERGY RISK MANAGEMENT INITIATIVES.	Docket No. E-01032C-00-0751
IN THEMATTER 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 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 UNISOURE 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

division has accrued a liability of approximately $135 million in unrecovered power costs. In the PPFAC case, Citizens had sought recovery of these costs through its Purchased Power and Fuel Adjustor Clause ("PPFAC"). Recovery of the unrecovered power costs would result in an approximate 45% increase in customers' rates.

Q. How does the settlement agreement mitigate this situation?

A. As part of UniSource's purchase of the Citizens gas and electric properties UniSource has agreed to forfeit any right to recover any of the $135 million electric power cost liability, and hold ratepayers completely harmless from the impacts of the dysfunctional power markets of 2000 and 2001. This term of the agreement also has the effect of reducing generation stranded costs to zero.

Q. Does this mean that Citizens electric customers will experience no change in rates?

A. No. Although Citizens' power is now supplied on a fixed rate contract, which protects customers from market fluctuations, the fixed cost of the power in the contract exceeds the cost of power that is embedded in current electric rates. Pursuant to the terms of the PPFAC, the incremental cost generally is recoverable through the PPFAC. This incremental cost will increase electric commodity rates per kwh by $0.01824, or approximately 22%.

Q. If the electric properties did not transfer to UniSource, would Citizens ratepayers still experience a rate increase?

A. Yes. The fixed cost of the power is the same whether Citizens retains ownership of the electric operations or transfers them to UniSource. Because Citizens, as yet, has not flowed through the fixed contract price to ratepayers, a 22% increase for the going-forward cost of power would still be necessary, absent the sale to UniSource. The advantage of the settlement agreement is that the necessary increase is limited to the going forward incremental cost of power and does not include recovery of the $135 million liability. Absent this agreement the rate increase would be 45% rather than 22%.

Q. What other terms of the settlement agreement benefit Citizens' electric customers?

A. The electric customers will experience a permanent write down of $93,624,000 in electric rate base. As a result, in future rate cases the level of investment for which UniSource is allowed to recover and earn a return will be $93.6 million less than it otherwise would be in Citizens' hands. The reduction in annual electric revenue requirement as a result of this write down is approximately $17 million.

The agreement also provides for a three year rate moratorium for electric customers. UniSource is precluded from seeking a rate increase during

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MARC SPITZER - Chairman
JIM IRVIN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON

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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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

OVERVIEW

Consolidation of the Three Cases

Although filed separately and on different dates, Staff believes that the three cases are inextricably linked and should be evaluated together. The three cases are linked because within the joint Citizens/UniSource application, UniSource modified both the Citizens request for a gas rate increase and Citizens request for a new PPFAC rate. UniSource reduced the requested increase in gas rates to reflect the difference between the book value and the purchase price along with other adjustments, reducing the requested increase in revenues from 28.9 percent to 20.9 percent. Also of great significance, UniSource modified the requested recovery of the under-recovered PPFAC balance estimated to be at least $135 million by July 28, 2003, to zero.

A Procedural Order was issued on February 7, 2003, recognizing the interdependence of the three cases and consolidating them. When UniSource and Citizens approached Staff to begin settlement negotiations, Staff accepted the invitation in the belief that the meshing of issues and the interdependency of relevant facts and requested approvals presented a logical and appropriate opportunity to resolve the three cases together.

Settlement Negotiations

On January 13, 2003, Staff organized a general meeting with the applicants and approximately 30 of the intervenors' representatives. At this meeting, the applicants discussed and described the application. On January 22nd and 31st, Staff held additional meetings during which Staff and the intervenors aired and discussed their issues and the applicants responded. Due to the abundant number of issues and the number of details that needed to be extensively discussed, it would have been unreasonably cumbersome for Staff to negotiate with the Joint Applicants with all other parties present. Therefore, Staff indicated that it would continue negotiations with Citizens and UniSource and that the other parties should attempt to come to an agreement with the applicants on an individual basis. On March 31st, Staff held a final meeting with the intervenors explaining the main points of the proposed Settlement Agreement and responded to the questions and concerns of the individual intervenors.

Summary of the Benefits of the Settlement Agreement

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

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

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

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

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

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

Electric competition remains at the forefront of Arizona regulatory issues. The Settlement Agreement contains a provision whereby within four months of approval of the Agreement, UniSource will file a plan to open the AED's service territory to retail electric competition by as a discussion of why Staff believes the Settlement Agreement regarding gas rate and accounting issues is "in the public interest."

Gas Rate Case Background

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

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

Because of the size and complexity of Citizens' 2002 base rate filing, in conjunction with other regulatory projects which were straining the internal resources of the Utilities Division expenses being assigned/allocated to Arizona utility properties. In this case, Citizens did a very thorough job of removing administrative office expenses that the ACC had previously disallowed, and furthermore, "capped" the total administrative office expense level to the amount found acceptable *in the 1993 rate case (i.e., $1.2 million).* In other words, Citizens has capped its administrative offices expense to a level found reasonable by the ACC nearly a decade ago.

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

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

Citizens' Cost of Capital Proposal

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%

UniSource's Settlement Cost of Capital

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%

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

- Customers will experience stability in power costs for the next five years (the remaining life of the New Contract).

- Customers will have the ability to choose alternative power suppliers in less than two years because the Settlement Agreement requires that the service territories for the present AED/the future ElecCo be open to retail electric competition by December 31, 2004.

- If customers find lower alternative power prices, they will be able to benefit from those prices without the burden of stranded costs.

- An incentive in the Settlement Agreement provides for electric customers to receive sixty (60) percent of any savings as a result of any successful renegotiations with Pinnacle West Capital Corporation ("PWCC") of the New Contract.

- The increase in electric rates will reflect only future actual power costs, resulting in a new adjustor rate of $0.01825 per kWh.

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

Electric PPFAC Case Background

The Settlement Agreement and acquisition by UniSource of Citizens electric assets will resolve all issues from Citizens' PPFAC case, Docket No. E-01032C-00-0751, in which Citizens requested major changes to its PPFAC. Citizens had originally requested full recovery of the under-recovered balance for purchase power costs that Citizens incurred. These costs were mainly due to a contract signed between Citizens and APS in 1995 (hereinafter referred to as the Old Contract). Citizens had requested a rate increase to collect the under-recovered balance (approximately $87 million as of June 2001) over a seven-year period. Citizens also requested recovery of all purchased power costs related to a new agreement that was negotiated between Citizens and PWCC effective June 1, 2001 (hereinafter referred to as the New Contract), plus a six (6) percent carrying charge for the under-recovered balance from the Old and New Contract. This total under-recovery is projected to be at least $135 million by July 28, 2003. In addition, Citizens requested an increase in the adjustor rate from $0.000 per kWh to $0.01825 per kWh to accommodate the costs of purchased power under the New Contract, as well as to reflect increased transmission costs.

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

. . .

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