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BEFORE THE ARIZONA CORPORATION COMMISSION

JEFF HATCH-MILLER
Chairman
WILLIAM A. MUNDELL
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner
BARRY WONG
Commissioner

Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR AN ACCOUNTING ORDER

DOCKET NO. E-04204A-06-0720

DECISION NO. 69202

ORDER

Open Meeting
December 19 and 20, 2006
Phoenix, Arizona

BY THE COMMISSION:

Introduction

On November 13, 2006, UNS Electric, Inc. ("UNS" or "Company") filed an application with the Arizona Corporation Commission ("Commission") for an accounting order requesting authority to defer mark-to-market accounting that would otherwise be required to be recorded as current period charges/credits or adjustments to the equity section in accordance with *Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments*. The application requests expedited consideration and approval to facilitate implementation for its financial statements to be issued for the period ending December 31, 2006.

Background

SFAS No. 133 requires reporting all derivatives at fair market price (mark-to-market). As an electric transmission and distribution utility, UNS has entered into certain transactions such as power supply and hedging agreements that are derivatives. Accordingly, differences between the contract prices and market prices are recorded as an unrealized gain or loss affecting the

Company's reported earnings and equity. To the extent that derivatives are related to costs that flow through UNS' purchased power and fuel adjustment clause "PPFAC," the associated unrealized gains and losses have no real economic consequence to the Company. As a result and contrary to the intended purpose of financial reporting and *SFAS No. 133*, unrealized gains and losses that have no economic consequence cause fluctuations in reported income and equity.

The Company proposes accounting treatment to counter the undesirable effects of recognizing unrealized gains and losses related to energy acquisitions and related hedging agreements on reported earnings and equity. UNS' proposed accounting treatment recognizes these unrealized gains and losses as regulatory deferred debits or credits in accordance with *SFAS No. 71, Accounting for the Effects of Certain Types of Regulation ("SFAS 71")* [1]. UNS asserts that it will neither seek rate base treatment for the requested *SFAS No. 133* deferral accounts nor cost recovery of any amounts temporarily recorded therein.

For its fiscal year ending December 31, 2006, UNS' has transactions that are subject to mark-to-market accounting. Although UNS presently derives no power from these agreements, UNS must mark them to market for power that it will not receive until 2008 because the agreements have been executed. If expeditious relief is not granted, UNS will have to report 2006 financials in accordance with *SFAS No. 133.* If relief is subsequently granted, the Company may be required to restate its 2006 financial reports.

UNS' longer term concerns with mark-to-market accounting relate to the replacement of a full requirements power supply agreement with Pinnacle West Capital Corporation ("PWCC") which has been serving UNS' load obligations in 2006. This agreement will expire on May 31, 2008. The agreement with PWCC is not a derivative and is not subject to the mark-to-market provisions of *SFAS No. 133*. However upon expiration of the PWCC contract, UNS will need to either renew that agreement or find other suppliers. The alternative contracts may be subject to *SFAS No. 133* and cause volatility in UNS' reported income and stockholders' equity resulting in suboptimal supplier selection. Volatility in the Company's reported earnings and the equity

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[1] *SFAS No. 71* provides for the establishment of regulatory assets and liabilities which may be realized through the regulatory process.

section of its balance sheet could result in a violation of its debt covenants as well as higher borrowing costs and, in turn, higher rates.

UNS proposes to defer recording of unrealized gains and losses in its income statement and/or equity accounts as would be required under *SFAS No. 133*. Instead, UNS would record offsetting debits and credits in the asset and liability sections of its balance sheet. UNS proposes to use FERC account No. 186, "Miscellaneous Deferred Debits" and FERC account No. 286, "Other Deferred Credits" to record the "changes in fair market value (unrealized gains and losses) of energy resource acquisition agreements and any related hedging agreements, defined as derivatives under *SFAS No. 133*..."[2]. Offsetting, non-cash entries would be recorded in FERC account No. 175, "Derivative Instrument Assets" or FERC account No. 244, "Derivative Instrument Liabilities."

Staff Analysis

Staff concludes that UNS' proposed alternative to mark-to-market accounting that recognizes unrealized gains and losses pertaining to energy acquisitions and related hedging agreements as regulatory deferred debits or credits in accordance with *SFAS No. 71, Accounting for the Effects of Certain Types of Regulation* provides: (1) a constructive avenue for eliminating unnecessary and inappropriate volatility in the Company's reported earnings and the equity section of its balance sheet; (2) a way to avoid unnecessary exposure to violations of its debt covenants; and (3) a way to circumvent potential dysfunctional influences on power acquisition decisions. Any authorized accounting order should have no direct impact on operating expenses or rate base. On the contrary, since a primary purpose of the alternate accounting is to avoid undesirable impacts on equity, the effect on equity of implementing any authorized alternate accounting should be considered, along with all other appropriate criteria, in determining UNS' equity for rate-making purposes.

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[2] Company's application, page 5, lines 3-4.

Staff Recommendation

Staff recommendations and conditions:

1. Approval of an accounting order for UNS for the sole purpose of recording unrealized gains and losses that would otherwise be recorded in accordance with *SFAS No. 133* due to changes in fair market value of energy resource acquisition agreements and any related hedging agreements defined as derivatives under *SFAS No. 133* as deferred debits and credits to the accounts discussed herein.

2. Requiring UNS to maintain accounting records sufficient to permit a detailed review of all transactions affected by this accounting order.

3. Specifying that the authorized accounting shall not have any direct effect on UNS' PPFAC.

4. That the authorized accounting become effective December 31, 2006.

5. Specifying that the authorized accounting shall not have any direct effect on the operating expenses recognized for rate-making purposes.

6. Specifying that the authorized accounting shall not have any direct effect on the rate base recognized for rate-making purposes.

7. Specifying that the effect of the authorized accounting on equity should be considered, along with all other appropriate criteria, in determining UNS' equity for rate-making purposes.

8. That the authorized accounting not provide UNS any direct incremental rate-making recovery.

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Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. UNS is a public service corporation that provides electric transmission and distribution services to approximately 91,000 retail customers in Mohave and Santa Cruz counties.

2. UNS has transactions that are subject to mark-to-market accounting for its fiscal year ending December 31, 2006,.

3. UNS seeks an accounting order:

. . .

a. Authorizing it to defer the recording of unrealized gains and losses in its income statement and/or equity accounts as would be required under *SFAS No. 133*. Instead, UNS would record offsetting debits and credits in the asset and liability sections of its balance sheet. Interim recording or unrealized gains and losses will not accurately state the amounts that are ultimately subject to recovery since UNS is a regulated entity that may recover those gains and losses through a PPFAC authorized by the jurisdictional authority resulting in the realization of previously recorded unrealized amounts.

b. To prevent unnecessary volatility in its earnings and equity balances caused by recording of unrealized gains and losses in its income statement and/or equity accounts as would be required under *SFAS No. 133*.

c. To prevent non-conformity with debt covenants that could raise the cost of borrowing caused by recording of unrealized gains and losses in its income statement and/or equity accounts as would be required under *SFAS No. 133*. Allowing UNS to use a deferral method of accounting in its application of SFAS No. 133 would eliminate the related volatility in earnings and equity that could result in non-conformity with debt covenants. Such non-compliance could result in higher borrowing costs and higher rates and impair UNS' ability to serve its customers, and preclude UNS from securing the most economical resources to meet its load obligations.

d. To provide a means whereby UNS can select the best supplier for its ratepayers without being guided by the accounting implications of derivative versus non-derivative types of instruments.

4. A deferral mechanism, similar to that requested in this Application, is already permitted in five other western states.

5. Staff's recommendations and conditions for approval of the Application are reasonable, appropriate and should be adopted.

CONCLUSIONS OF LAW

1. The Company is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-281 and 40-282.

2. The Commission has jurisdiction over the Company and of the subject matter of the application.

3. It is in the public interest to approve the Company's Application to defer unrealized gains and losses due to changes in fair market value of energy resource acquisition agreements and

any related hedging agreements defined as derivatives under *SFAS No. 133*, as recommended by Staff and with Staff's conditions.

ORDER

IT IS THEREFORE ORDERED that the Application and Staff's recommended conditions herein are approved.

IT IS FURTHER ORDERED that this Decision shall become effective December 31, 2006.

BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this 21st day of December, 2006.

BRIAN C. McNEIL
Executive Director

DISSENT: ______________________

DISSENT: ______________________

EGJ:GWB:lhm\JMA

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