



1 BEFORE THE ARIZONA CORPORATI

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3 IN THE MATTER OF THE) DOCKET NO.
4 REORGANIZATION OF UNISOURCE) E-04230A-03-0933
5 ENERGY CORPORATION.)
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8 At: Tucson, Arizona

9 Date: June 22, 2004

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ORIGINAL

1 BE REMEMBERED that the above-entitled and
2 numbered matter came on regularly to be heard before the
3 Arizona Corporation Commission, in Room 222 of said
4 Commission, 400 West Congress, Tucson, Arizona,
5 commencing at 9:10 a.m., on the 22nd day of June, 2004.

6
7 BEFORE: WILLIAM A. MUNDELL, Commissioner
8 JEFF HATCH-MILLER, Commissioner
MIKE GLEASON, Commissioner

9 JANE L. RODDA, Administrative Law Judge

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1 ALJ RODDA: Good morning, everyone. We're
2 back live, and we're back on the record.

3 Mr. Pignatelli is still on the stand, and we
4 are going to start with -- I'm sorry, Mr. Heyman, that's
5 right, you were going to --

6 MR. HEYMAN: Good morning, Your Honor, and
7 good morning, Commissioners.

8 Yesterday, Commissioner Mundell and
9 Commissioner Mayes raised an issue about the
10 confidentiality of the board minutes and whether or not
11 we would waive that confidentiality so that there could
12 be questions asked regarding those minutes.

13 UniSource wants to protect the
14 confidentiality of board minutes. We think that's an
15 important corporate protection. However, for the
16 purposes of this hearing, we are willing to extend a
17 limited waiver of the board minutes similarly to the
18 waiver that we extended regarding the STAC Committee
19 meeting minutes, and that is that we would allow
20 questions to be asked from the minutes, we would allow
21 answers to refer to the minutes, portions could be read
22 into the record from the minutes. We would just ask
23 that the minutes themselves, the documents not be
24 attached to the public record and that they retain their
25 confidentiality. Again, the reason for this is the

1 confidentiality that is afforded in the law to board
2 minutes to protect the corporation.

3 The reason that we are extending the limited
4 waiver is because Commissioners have asked for it during
5 the course of this administrative proceeding, and we
6 believe that many of the things that were time sensitive
7 are no longer time sensitive. I hope that helps the
8 proceedings proceed more smoothly.

9 ALJ RODDA: I think that that will help
10 greatly, so I appreciate that.

11 MR. HEYMAN: Thank you for letting me put
12 that on the record.

13 ALJ RODDA: Thank you for reminding me. And
14 we were going to commence this morning with the
15 cross-examination by Mr. Magruder.

16

17 CROSS-EXAMINATION

18

19 Q. (BY MR. MAGRUDER) Good morning,
20 Mr. Pignatelli, and Judge and Commissioners. It's hard
21 for me to see from the seat I am in, so I decided to
22 stand up to the podium, if you don't mind.

23 In general, there's been little concern
24 about the day-to-day present operations of your company
25 from the questions from the people. Most people seem to

1 be concerned about the future, and what's going to
2 happen after the acquisition. And therefore, I ask why
3 isn't your partner, Mr. Rentschler, testifying today or
4 sitting beside you in a panel so that we can hear what
5 the future will be instead of just what your promises
6 for the future will be for your new organization?

7 A. Well, Mr. Rentschler is certainly here and
8 available, but I am prepared to discuss the future,
9 hopefully as eloquently as he would.

10 Q. But could you possibly say that the
11 confidence would possibly increase if we could also see
12 and talk to him during these hearings?

13 A. Well, in these proceedings, we've, we're
14 pro-offering a panel after I'm finished of the investors
15 for you to have, to ask questions of. We thought that
16 that was adequate to satisfy, but if you determine that
17 to be inadequate, then subject to counsel's advice,
18 we're not trying to hide any balls.

19 Q. I understand that. But the relationship
20 when corporations and organizations buy other
21 organizations, traditionally, the first phase is the
22 honeymoon phase, and I consider you're probably in the
23 honeymoon phase with all of these different
24 organizations. Would you probably agree with that?

25 A. Nothing has been consummated to date, so I

1 don't know that I'm in the honeymoon state.

2 Q. Okay. The next phase turns out to be the
3 real implementation phase, and then sometimes I hate to
4 say it, you end up in the divorce phase where it gets
5 pretty bad. We are all talking now, everything is
6 copacetic, but by having both of you together, we could
7 maybe see how you interact and see possibly if there are
8 any future problems. But that's okay.

9 A. I think that you, you have to realize that
10 the day-to-day operations of this entity today,
11 tomorrow, and for at least the next five years is going
12 to be at my discretion. Mr. Rentschler will be one
13 member of the board of a board of five --

14 Q. Okay.

15 A. -- and as I explained, the function of the
16 board, and I've discussed this at length with
17 Mr. Rentschler, he looks at the board function to look
18 at strategy, financing and financial matters, and
19 succession planning, not day-to-day operations.

20 Q. Could you give me the definition or your
21 definition of the difference between a general partner
22 and a limited partner that will occur in these
23 organizations?

24 MR. HEYMAN: Objection, Your Honor, calls
25 for a legal conclusion.

1 ALJ RODDA: Okay. Do you want to rephrase?

2 MR. MAGRUDER: I'll try to rephrase it.

3 Q. (BY MR. MAGRUDER) In the new organization,
4 there will be a general partner and a limited partner.
5 Do you see how they will work together with the board
6 and with you?

7 MR. HEYMAN: Good enough for me.

8 ALJ RODDA: Me, too.

9 THE WITNESS: Those entities will not work
10 together with the board or with me. I work with the
11 board. The board is elected by the shareholders.

12 Q. (BY MR. MAGRUDER) Okay. How are the board
13 members selected?

14 A. Generally we will have an independent
15 director as defined by the SEC is what qualifies as
16 independent. That board member will be the head of the
17 corporate governance/nominating committee, and that,
18 there will be a totally independent committee made up of
19 independent directors which are in charge of bringing
20 nominations to the full board for recommendation to the
21 shareholders for the shareholders' vote.

22 Q. And that board then has, if I remember from
23 yesterday, two independent directors, and then one from
24 each of the investor companies, is that correct, sir?

25 A. That is incorrect, sir. What we have

1 committed to was two independent directors, two Arizona
2 directors, one director which represents the investors.

3 Q. So you just discussed five, two Arizona, two
4 independent, and one to represent the investors, is that
5 correct?

6 A. That's correct, but the independent and
7 Arizona may not be mutually exclusive.

8 Q. I understand.

9 Would there be any -- as an Arizonan, I
10 would personally like to have three from Arizona. Is
11 there any possibility that you would have a majority of
12 your board from our state?

13 A. I don't know. Are we negotiating or are
14 we -- yes, there is a possibility.

15 Q. Because I think that might give us a little
16 more confidence in the makeup of the board since they
17 will be living in this state, preferably from the
18 service territory that your company is involved in.

19 A. It's actually my current intention that
20 there would be three directors from Arizona, not
21 necessarily from the exact service territory, but that,
22 we'll take that into consideration.

23 Q. Thank you.

24 Your company has a legacy in Tucson for over
25 100 years and has earned the support of the general

1 population. That's pretty obvious from testimony by
2 others in this hearing, and you've received rewards for
3 outstanding service which resulted as a result of human
4 training, awareness, and deliberate company policies.
5 Hypothetically, let's say the board requested, looked at
6 your budget for the year and said, "Gee, you know, the
7 service center is too high. Why don't we reduce it by
8 25 percent next year." What would be your reaction to
9 that hypothetical suggestion?

10 A. I would say, "That's your opinion. I'm here
11 to manage this company, to run this company day to day,
12 and that service center is required."

13 Q. But it's just a 25 percent reduction. That
14 doesn't mean you're not going to have a service center.
15 They want more income.

16 A. I will do what's right for the safe,
17 reliable service and to meet customer needs in my
18 communities that I serve, that I have an obligation to
19 serve.

20 Q. Okay.

21 Different subject: During the
22 Citizens-UniSource acquisition hearings last summer, you
23 were eloquent in testifying how Citizens joining
24 UniSource, it would be very beneficial financially for
25 the Citizens organization, for the former Citizens

1 companies. During the testimony we've heard in these
2 hearings, it looks like something happened, and it
3 hasn't been so beneficial, that there are problems in
4 the finances with TEP. What happened? Why didn't it
5 turn out to be as nicely discussed as it was a year ago,
6 almost a year ago?

7 A. You've mixed two companies, sir. UES I
8 committed -- that's what owns UniSource Electric and
9 UniSource Gas -- we committed to 40 percent equity. We
10 did that. We committed to financing; we did that. We
11 committed to certain rate levels; we've done that. We
12 committed to enhance service, and we have made
13 significant progress in improving service levels. We've
14 taken actions which I could and will I'm sure in another
15 question delineate for you. That's separate from TEP.

16 Q. I understand.

17 A. What I have said about TEP is TEP has a weak
18 financial structure at the present time, and this
19 acquisition, this merger with new investors putting
20 massive amounts of dollars into TEP will strengthen TEP
21 in a time of change in this industry.

22 Q. This isn't in my written thing, so I will
23 try again. But from my understand, some of the money is
24 going to help TEP but the obligation for that money is
25 going up to UniSource. So UniSource will not be in the

1 same financial situation it was before. When the senior
2 company over the two equal next level companies, when
3 the senior company gains additional debt and it then may
4 have problems, won't that then hurt the benefits that
5 have been accruing for UES? Because I'm a UES customer;
6 that's what I'm interested in.

7 A. No, it won't. UES as a result of this
8 transaction will have a revolving credit line of
9 \$40 million which it doesn't have now to provide
10 additional liquidity, and we are putting ring fencing in
11 between UES and UniSource and between TEP and UniSource
12 so that the public entities, the jurisdictional
13 entities, those entities which provide safe and reliable
14 service to all of the customers which we serve are
15 protected from any aberration at the holding company.

16 Q. Shouldn't ring fencing already be in place
17 between each of the three public service companies,
18 because each has its own financial books that are
19 independent of the other?

20 A. We treat each individually, independently,
21 and I think there's a high element of ring fencing,
22 legal ring fencing already in place because of the
23 Commission's affiliate transaction rules. We cannot
24 loan money between entities, we cannot transfer property
25 between entities, we cannot guarantee debts of one

1 another. Yes, there is sufficient, but we are putting
2 in further protections to meet the concerns raised by
3 individuals who are participating in this proceeding, to
4 meet the concerns of the Staff, and to give the
5 Commission 40 additional strengths, powers, conditions,
6 over UES Electric and Gas and TEP.

7 Q. You indicated that UES now is at 40 percent.
8 Your last quarterly report 10(Q) of March 31st indicated
9 it was 37 percent for UES. What happened?

10 A. Nothing. There's a minor difference right
11 now; it's between 37 and 40. It's about two million we
12 are working towards. We didn't take any money out,
13 haven't done anything untoward. It was just the
14 original capitalization, how it was set up.

15 Q. Okay. At present, your company makes dozens
16 of reports to the Arizona Corporation Commission,
17 Securities and Exchange Corporation, Federal Energy
18 Regulation Corporation, Internal Revenue Service. Will
19 all -- I am saying all in the total sense of these
20 financial reliability, complaints, and other reports
21 required by all of these agencies still be submitted to
22 the same level of content as before this acquisition, as
23 before the acquisition?

24 A. Yes.

25 Q. Okay. Will the same Securities and Exchange

1 forms and reports be posted on your website after the
2 acquisition as they are now?

3 A. I believe so. I can only say if, if the
4 debt is privately held, there may be some change in the
5 actual forms filed.

6 Q. I understand that, yes. But you will submit
7 the appropriate SEC forms, and we will be able to see a
8 10(Q) and a 10(K) every three months or so?

9 A. I believe, yes. I am just saying we will
10 submit every form, and I think they'll all be the same.

11 Q. Other than forms due to, for example,
12 private debt, will there be any that will not be
13 submitted, any reporting --

14 A. Not to my knowledge.

15 Q. Okay.

16 Who will sign the SEC annual 10(K) and
17 quarterly 10(Q) forms to verify compliance with
18 Sarbanes-Oxley Act?

19 A. Myself and the chief financial officer, just
20 like we do now.

21 Q. Just like the way you did before, okay.

22 A. If we are subject to Sarbanes-Oxley. I
23 don't know where that law is going to go. I am just
24 saying that the same people will sign those affidavits.

25 Q. And you will have the same responsibilities

1 until the wording underneath it that you verified that
2 that information is correct?

3 A. Yes.

4 Q. What would happen if Sage, Saguaro, or some
5 affiliate wants to suppress information that would
6 normally be contained in one of these reports? Let's
7 say there was a little legal dispute that might affect
8 an affiliate or someone else. Would you, would you
9 suppress that information?

10 A. No. I'm not going to do a perp walk. I'd
11 go to jail for things like that.

12 Q. I am not asking you to go to jail. You are
13 going to say no to any outside influence that is trying
14 to change your report?

15 A. That's correct, sir.

16 Q. Okay. Good.

17 Will you comply as a public service company
18 or a private company in compliance with Article 3,
19 Section 13 of the Arizona Constitution to submit reports
20 to the ACC? I believe the answer will be yes, but let
21 me read that. It's Report to the Arizona Corporation
22 Commission Section 13, "All public service corporations
23 and corporations whose stock shall be offered for sale
24 to the public shall make reports to the Corporation
25 Commission under oath and provide such information

1 concerning their acts and operations that may be
2 required by law and by the Corporation Commission."

3 Will the new company comply with that?

4 A. Yes.

5 Q. Okay. Will UniSource and its utility
6 officials still be classified as a public service
7 company in accordance with the Arizona Revised Statute
8 and any other definitions?

9 MR. HEYMAN: Your Honor, I would like to
10 object, but give Mr. Magruder an opportunity to restate
11 that. I think that, number one, it calls for a legal
12 conclusion, but number two, I think UniSource is not
13 currently considered a public service corporation.

14 MR. MAGRUDER: I didn't ask UniSource. I
15 was asking TEP, UniSource Electricity, and UniSource
16 Gas, will they still be classified public service
17 companies after the acquisition.

18 MR. HEYMAN: That still calls for a legal
19 conclusion.

20 MR. MAGRUDER: Let me try again.

21 Q. (BY MR. MAGRUDER) In your view, from the
22 present way you handle your companies, these three
23 companies, will you handle them in the general manner of
24 a public service company in the State of Arizona?

25 A. Yes.

1 ALJ RODDA: Thank you, Mr. Magruder.

2 THE WITNESS: Yes, there's no intention that
3 this transaction reduces the amount of oversight that
4 this Commission has over the jurisdictional companies,
5 UniSource Electric, UniSource Gas, and TEP. In fact,
6 the oversight will be enhanced from what its current
7 level is to what it is with the new conditions.

8 Q. (BY MR. MAGRUDER) Have any directors or
9 executives sold stock since the announcement of this
10 merger?

11 A. None to my knowledge.

12 Q. I have a series of SEC Form 4, for example,
13 one for James S. Pignatelli, exercised on 17 June 2004,
14 last Friday, that discusses some options that you
15 exercised. Would you consider that the same as selling
16 stock?

17 A. I didn't exercise any options. I'm sorry.

18 Q. Well, it says this is equivalent to
19 dividends with respect to declared by the issuer as its
20 common stock created on March 10th, 2004, under the
21 UniSource Energy Corporation Omnibus Stock and Incentive
22 Plan. Do you want me to show you this form? If you
23 want to see it --

24 A. I have not sold any stock.

25 Q. I have, I have a few form forms which are

1 people selling stock that are members of boards of
2 directors and executives in this company, and I have
3 many of these sheets of paper since May.

4 MR. HEYMAN: Excuse me, I would like to
5 interpose an objection. We are getting argumentative
6 here. It might help, Mr. Magruder was looking at a form
7 that talked about dividends that were declared. I think
8 that's what you said in your question.

9 MR. MAGRUDER: I used his example. Here is
10 Mr. Glaser's.

11 MR. HEYMAN: My objection is we are arguing
12 about documents that don't have a foundation.

13 ALJ RODDA: Right. I guess we need to
14 identify the documents. No one, I certainly have no
15 idea what you're talking about. I mean, I don't know
16 what documents you are referring to, and I guess I --

17 MR. MAGRUDER: I'll change it, the subject
18 just slightly and ask a different question. Let me see
19 if I can find this.

20 Q. (BY MR. MAGRUDER) I have a copy of your
21 last quarterly report to the Securities and Exchange
22 Commission, and under this section, it says, "In the
23 first quarter of 2004, net cash flows from operating
24 activities increased by 32 million compared with the
25 same period in 2003. The following factors contributed

1 to this," and I will just read one, "a \$5 million
2 increase in wages paid to, primarily to, \$4 million of
3 wages paid to UES and incentive compensation payments to
4 management pursuant to their employment arrangements
5 triggered by the shareholder approval of the proposed
6 acquisition of UniSource Energy."

7 Has there been a bonus offered to various
8 members of your Staff as a result of activities
9 involving this acquisition?

10 A. There may have been some bonuses paid to the
11 Staff, but I believe what that is referring to is
12 expensing options which became vested upon the vote, the
13 positive vote. And I think it is an expense that had to
14 be recorded as a result of that --

15 Q. So --

16 A. -- for past performance bonuses and things
17 of that nature which were accelerated by the vote.

18 Q. Okay. So that might account for these
19 various board, members of the board of directors and
20 executives in the company receiving compensation for
21 various stock options?

22 A. You would have to rethink that question and
23 restate it because that question did not make any sense
24 to me.

25 Q. Okay. Without going through these papers

1 here, but it appears from your website, which is where I
2 gathered this information, a series of reports have been
3 filed when top management and directors sell or exchange
4 or receive financial benefits in the form of stock and a
5 payment for that stock. And my question really is some
6 of these appear to be related to this ongoing
7 acquisition. Is that correct?

8 A. Some of these may. I, I don't know.

9 Q. Okay. I have my quote in the record, so
10 we'll see what -- people can read it and make their
11 decision later.

12 A. I think that some of it is because there
13 were options that were lapsing in July, and the officers
14 were exercising their options which create a Form 1,
15 Form 4 filing. I think that that's probably what it is.
16 I was not, I did not have any options which lapsed in
17 July, or June, so that's why I know I have not done any
18 transactions.

19 Q. Okay. What rate of return on their
20 investment do you forecast for the new owners next year,
21 the year 2005?

22 A. I don't forecast rate of return on their
23 investment.

24 Q. Okay.

25 New subject: What percentage of the

1 electricity sold by Tucson Electric is from coal-fired
2 power plants?

3 A. About 90 percent.

4 Q. Okay. And what percentage of the
5 electricity sold by UES or UniSource Electricity is from
6 natural gas?

7 A. I really don't know where the energy comes
8 from for UES Electric because that is under a contract
9 with Pinnacle, and I don't know whether it's coming from
10 gas, from nuclear, or where.

11 Q. New subject: In Santa Cruz County, the
12 largest payer of property tax is your company, in the
13 county. Since UniSource is being sold at a 65 percent
14 premium, will your future property taxes increase for
15 our county?

16 A. Frankly, I don't know how property taxes are
17 assessed. I don't know what goes into the assessment of
18 property taxes. I personally don't know that. I
19 haven't done property taxes for years, and I don't know
20 if it's value based or original cost based. I have no
21 idea.

22 Q. The concern in Santa Cruz County is the loss
23 of over \$1 million in property tax when Citizens was
24 sold at 45 cents to a dollar book value, and that means
25 the schools are laying off teachers, which is very

1 important in the smallest county in this state. So I
2 would appreciate maybe if you could possibly have
3 somebody do a little bit of research and maybe submit a
4 paper or something to the docket so the people could
5 look at both of these interactions. One is a decrease
6 in revenue and one is an increase. Hopefully, it
7 balances out and we only have one year of lower taxes in
8 our county.

9 COMMISSIONER MUNDELL: To that point, I
10 would also like that. That was one of the questions I
11 asked, and the response was "We will comply with all
12 current laws." I sort of knew that already.

13 My question is more directed at what
14 Mr. Magruder is asking because of the change, and I was
15 going to ask some of these questions myself, because of
16 the change in the structure of the holding companies,
17 et cetera, et cetera, what is the bottom line change in
18 taxes to these counties and the state. The answer was
19 we will comply with the state and federal, or state
20 laws. Well, sure.

21 THE WITNESS: I, if that was the answer, I
22 think it is being misinterpreted.

23 I can't tell you exactly the taxes because
24 that's a function of revenue and expenses, but the
25 intention of that answer is that there is nothing in

1 this transaction that is intended to change any of the
2 taxability of any elements of these companies. I
3 personally don't know how property taxes are derived. I
4 know a little more about how income taxes are derived,
5 but the intention was not to be flip or not to provide
6 you with an adequate answer, Commissioner. It's just
7 that there are many things that go into, as you know,
8 into the computation of taxes.

9 COMMISSIONER MUNDELL: Well, I would like to
10 know the actual answer. Let me read the answer. "The
11 Arizona tax treatment of the companies will not change
12 as a result of the merger. Saguaro, UniSource Energy
13 and its utility subsidiaries will be Arizona
14 corporations that are subject to the same state laws and
15 regulations relating to property, sales, use, and income
16 taxes."

17 My question was, you know, will there be any
18 loss of tax revenue to Arizona at the state, county or
19 city level. The answer was, "We are going to comply."
20 So I am trying to understand, because there is going to
21 be a change in the holding companies and the makeup of
22 the structure, what's the, what will actually happen
23 from a tax perspective, both on the federal and state
24 level. If there isn't any --

25 THE WITNESS: The answer is intended to

1 assure you that the structure is not going to do
2 anything to move taxes out of the state or into the
3 state, that if you tell me what the revenue and expenses
4 are in your assumptions, I will tell you what the taxes
5 are. I can't tell you tomorrow, and you would be loathe
6 to have me do this on the stand, to say that next year,
7 UniSource is going to pay 10 million in state income
8 taxes, and then whatever revenues and expenses change
9 and we don't spend 10 million. The answer to your
10 question is there is nothing nefarious in the structure
11 to move any tax incident or reduce tax incident in the
12 state.

13 COMMISSIONER MUNDELL: Well, you use the
14 word nefarious. I am not suggesting it's nefarious. I
15 am saying we have some people here that are very
16 sophisticated that understand the tax laws both on the
17 federal and state level. We've got movement on the
18 federal level with PUHCA, we've got the energy bill
19 floating around in Congress. There's a lot of moving
20 parts here. So Mr. Magruder is asking about county
21 taxes right now, and I think his questions are well
22 taken. I am trying to step back and look at the big
23 picture and I will ask the questions when it's
24 appropriate.

25 MR. HEYMAN: Commissioner Mundell, I am

1 getting whispers from people who know the answer. Maybe
2 at a break, we can provide that information to
3 Mr. Pignatelli so that he can get that information to
4 you.

5 COMMISSIONER MUNDELL: Maybe the panel
6 tomorrow can answer the questions, because again, there
7 are a lot of moving parts here.

8 THE WITNESS: But Commissioner, that in and
9 of itself, not to be argumentative, change in tax laws
10 at the federal level, change in deductions, different
11 things in the federal will change taxation, not because
12 of anything we're doing, not because of any
13 restructuring we're undertaking, but simply because of
14 the change in law.

15 COMMISSIONER MUNDELL: Well, I think there's
16 an issue as I understand it in Oregon with a change in
17 the amount of taxes that were paid because of the change
18 in the structure based on, you know, a purchase there.
19 So I don't know the answers to these questions. I just
20 know the questions to ask. So you are making it sound
21 like there's no, there will be no change. I want to
22 hear it under oath from folks tomorrow, and if you don't
23 know the answer, that's fine. But I know there's an
24 issue in Oregon based on the amount of taxes that were
25 paid pre- and post-merger by private investors.

1 purchasing the utility company up there.

2 Q. (BY MR. MAGRUDER) I'll try to rephrase mine
3 and give some statistics. Your company is the largest
4 property owner in value in Santa Cruz County, and
5 generally value is a function of fair market value.

6 When a property is sold, all of a sudden, like selling a
7 house, you have a new fair market value of that house.
8 When it was sold at 45 cents to a dollar is where we
9 looked at the decrease, and now we're looking at a
10 65 percent premium on this second sale. We're
11 interested in what that, our question is what is that
12 impact on our property taxes, and I would appreciate an
13 answer later sometime. Thank you.

14 A. That's fine.

15 Q. In addition to the 660 -- start again. In
16 addition to the 660 million this deal will add to
17 UniSource/TEP's debt, your testimony on page 28
18 discussed a proposed transmission line to Mexico. Where
19 will the additional money for this project come other
20 than adding more debt to UniSource?

21 A. I hate to take exception to your question,
22 but we're not adding \$660 million of additional debt to
23 TEP.

24 Q. Okay.

25 A. So if you excise the first part of your

1 question --

2 Q. That's fine.

3 A. -- I'll answer your question.

4 Q. That's fine. I'll excise it.

5 A. We haven't determined how we'll finance that
6 at this point in time, whether we'll bring a third party
7 financing in or whether we will put it into rate base.
8 That will be determined when that project is a little
9 further down the road.

10 Q. I as a ratepayer for UES am concerned on
11 that issue, and in particular, in January of 2001, TEP
12 agreed with Citizens, which is now UES, that Citizens
13 would only pay seven and a half million dollars for that
14 transmission line. Is that agreement still in effect?

15 A. Any agreement that we made with Citizens is
16 still in effect as far as what will be allocated, but
17 just as you are concerned about the cost, you are also
18 concerned about the reliability of service to your area,
19 and I believe that it's in your best interest as a
20 consumer to have a secondary feed to you.

21 Q. And I don't want to get argumentative on
22 that, but on the 25th or 6th of next month we will
23 discuss that issue again, and I have a separate proposal
24 which I feel is equally as reliable at about 10 to
25 15 percent the cost.

1 A. I'll be interested to hear that.

2 Q. It has been submitted and it is in the
3 docket.

4 A. Thank you.

5 Q. Am I correct to say that -- no, I've already
6 done that. I've asked that question.

7 Will this transmission line allow your
8 company to recover the federal energy regulatory return
9 on investment for transmission lines?

10 A. As I have indicated, we haven't determined
11 whether that line -- a portion of it will be under ACC
12 jurisdiction. We haven't determined exactly how that
13 will be either financed or who it will be charged to or
14 how it will be done.

15 Q. It is my understanding, and I'd like you to
16 confirm or deny it, that the Federal Energy Regulatory
17 Commission allows 13 percent return on investment for
18 interstate transmission lines.

19 A. I think the Federal Energy Regulatory
20 Commission allows different rates for different
21 transmission lines, different owners, different states.
22 I have not been in a Federal Energy Regulatory
23 Commission proceeding for about 25 years, so I don't
24 know what rate of return they're allowing at this time.

25 Q. I think we're talking apples and oranges.

1 I'm talking about the return on the capital investment
2 in the transmission line, and in the last two years, due
3 to transmission line grid problems throughout the
4 nation, FERC has allowed anyone, if I'm not mistaken,
5 that builds a transmission line to receive a 13 percent
6 profit, just to build the line. And that's all I'm
7 talking about, a rate of return on investment.

8 A. I don't think you're correct.

9 Q. Okay.

10 A. That's not my understanding, that I could
11 build a line and FERC would give me 13 percent profit
12 for building the line. I don't think you're correct.

13 Q. I've heard testimony from Mr. Woods on that
14 subject before Congress, and that's my source of
15 information. But I might be wrong, and I will back off
16 on that.

17 ALJ RODDA: Can we just try to limit it to
18 questions instead of discussion?

19 MR. MAGRUDER: Okay.

20 Q. (BY MR. MAGRUDER) Both your residential
21 permit and the Arizona Corporation Commission Line
22 Siting Commission state that these permits are for a
23 transmission line from Sahuarita to Santa Ana in Sonora,
24 Mexico. Who is going to pay for the \$60 million of new
25 transmission line in Mexico?

1 A. CFE.

2 Q. Has CFE signed an agreement to that?

3 A. We are, last I checked, they were working on
4 a mutual construction agreement. I don't think it's
5 been signed at this point in time.

6 Q. When will the Mexican part of this line be
7 completed which is a part of your improvement of
8 reliability for Santa Cruz County?

9 MR. HEYMAN: Excuse me, Your Honor, I would
10 like to object. I have let it go a little bit, but
11 unless Mr. Magruder can tie it to the merger and impact
12 of the merger, I would object as irrelevant.

13 ALJ RODDA: Mr. Magruder, can you tell us
14 why this line of questioning is relevant?

15 MR. MAGRUDER: In my opinion, this line is
16 going to cost over \$100 million which would add an
17 expense to this new company, and I am curious as to how
18 that expense is going to be handled since it is not
19 discussed in the documents to date.

20 MR. HEYMAN: Let me impose another objection
21 then because I think there is a lack of foundation.
22 When he said there is going to be \$100 million to this
23 new company, Mr. Pignatelli's testimony has been he
24 doesn't know how it is going to be financed, so we don't
25 know who will incur the cost of the line. That's why if

1 the questions can be tied to specifically the merger,
2 the merits of the merger, the consequences of the
3 merger, I might not object, but because he has not been
4 able to do that, I would impose an objection that it's
5 irrelevant.

6 MR. MAGRUDER: That's fine. I'll change,
7 because I have something that might be more relevant on
8 this same subject.

9 Q. (BY MR. MAGRUDER) Has this project been
10 discussed with any of the new owners and a company
11 called ITC?

12 A. No.

13 Q. Okay. Have you heard of ITC?

14 A. Yes.

15 Q. And do you know that's a KKR subsidiary?

16 A. No, it's not a KKR subsidiary. They have
17 made an investment in the company.

18 Q. An investment.

19 Is there a company called Haddington Energy
20 Partners II Limited Partnership under your jurisdiction
21 now?

22 A. No. We have a small investment in
23 Haddington Investment Partners.

24 Q. And is the general manager of that also on
25 the board of directors of your company?

1 A. That's correct.

2 Q. Is Haddington a part of one of the
3 investments from one of the three investors in your,
4 that are investing in your company?

5 A. I believe that J.P. Morgan has an investment
6 in Haddington.

7 Q. In Haddington. So here is one investment
8 you have invested in and also J.P. Morgan has invested
9 in, is that correct?

10 A. Yes.

11 MR. HEYMAN: Your Honor, I don't want to
12 keep on interposing an objection, but I realize there is
13 a transcript being made, and Mr. Magruder's question
14 said "you" to Mr. Pignatelli, and I want to clarify who
15 exactly it is that is making the investment.

16 Q. (BY MR. MAGRUDER) Who has made the
17 investment in UniSource?

18 A. The shareholders of UniSource. It's in the
19 UniSource entity. It's not at TEP, not at UES Electric
20 and Gas.

21 Q. But it is a part of this acquisition and
22 would go to Saguaro at the completion of this
23 proceedings?

24 A. It is among the assets, yes, because
25 included in the \$25 and 25 cents purchase is the

1 acquisition of the unregulated entities, Global Solar,
2 and these other investments.

3 Q. Is there any possible conflict of interest
4 between a member of your board of directors on that, as
5 a general manager of that organization, and J.P. Morgan?

6 A. That particular director recused himself
7 from all discussions concerning this acquisition, and it
8 is noted he is not a member of the Strategic Advisory
9 Committee, he did not vote, he did not participate in
10 any board meeting that the acquisition was discussed at
11 because he felt he had a conflict and was advised by his
12 counsel, even though I didn't necessarily agree, that he
13 had a conflict.

14 Q. Thank you for clarifying that point.

15 Did I read in your testimony that you
16 started about five years ago to discuss the sale of your
17 company to outside investors?

18 A. Mr. Magruder, I have an obligation to my
19 investors, and I have been approached periodically every
20 year that I've been in TEP with individuals who, or
21 companies, corporations, private, some other utilities
22 who wanted to look at merger or acquisition. That is a
23 continuous function that goes on every day.

24 Q. Fine. About three years ago, you did start
25 discussions with the present team that is trying to

1 acquire your company, is that correct?

2 MR. GLASER: Can I give him his glasses,
3 Your Honor?

4 ALJ RODDA: Yes, certainly.

5 MR. HEYMAN: No telling what answers we may
6 get if he doesn't have his glasses.

7 THE WITNESS: I have had discussions on and
8 off with predecessors, with J.P. Morgan Chase, with
9 people at KKR over investments in our unregulated
10 entities, over possible cash infusions at TEP to help us
11 right our structure and become a stronger entity for at
12 least three years, just different people, different
13 times. This is in the normal course of business.

14 Q. (BY MR. MAGRUDER) Did you report this to
15 the board of directors?

16 A. The board of directors functions in the same
17 responsibility that I have. They hold me accountable to
18 making sure that I answer anybody who is interested in
19 looking at the company. That's my obligation. I bring
20 it to the board of directors when I believe there is
21 anything to be brought to the board of directors.

22 Q. And so about three years ago, you started
23 your discussions with the board of directors on some of
24 the present investors interested in your company?

25 A. You keep saying three years ago. I don't go

1 back that far, so, I mean, in this. I show that we
2 signed a confidentiality agreement with J.P. Morgan
3 Group on July the 19th, 2002.

4 Q. 2002, okay. Was that the first real sincere
5 person, group that had shown interest in your company?

6 A. No. Probably eight years ago, another
7 utility showed a sincere -- it was before I was
8 chairman -- showed a sincere interest. Of course, they
9 would have taken the headquarters out of Tucson, and
10 they would have not utilized current management and they
11 would have a parade of horrors.

12 Q. How has, since signing that nondisclosure
13 agreement in 2002, how has this, since then, how has
14 this potential sale of your company impacted your
15 strategic planning, and in particular, TEP's business
16 plan?

17 A. It hasn't impacted it at all, sir. I just
18 spent three days with my directors going through
19 strategically what we needed for generation to meet the
20 needs of our customers and strategically what we needed
21 in additional transmission facilities to insure safe,
22 reliable service. I am operating this company in the
23 best interest of the State of Arizona today, just like I
24 did yesterday, and this transaction has not changed my
25 planning horizon in any manner.

1 Q. I understand that you were in negotiations,
2 in fairly serious negotiations, before the
3 Citizens/UniSource acquisition, and then you, what's the
4 right word, you stopped discussing until that, after
5 that acquisition was completed, is that correct?

6 A. We had signed confidentiality agreements
7 with J.P. Morgan Group prior to the acquisition of
8 Citizens. On October 29th, 2002, we executed our
9 agreement with Citizens to acquire the assets, and in
10 November, the first part of November, I notified the
11 group that we were no longer interested in the
12 transaction, that we were going to continue to prosecute
13 the Citizens acquisition, and I did not want to be
14 bothered by them at a time when I was doing something
15 which I felt was in the best interest of the State of
16 Arizona.

17 Q. Okay. In this same time frame in 2002, did
18 you notify the Corporation Commission before you
19 submitted the application on the Citizens acquisition?

20 A. No, sir. What would I notify them of?

21 Q. Did they have any inkling of that
22 acquisition prior to receiving the Joint Application for
23 the merger of UniSource and Citizens?

24 MR. HEYMAN: Could I ask for a
25 clarification? That acquisition meaning the

1 Citizens --

2 MR. MAGRUDER: The Citizens acquisition.

3 Q. (BY MR. MAGRUDER) Did they know about that
4 in advance before you submitted the application?

5 A. Did they know about what in advance? I'm
6 sorry.

7 Q. That you were looking at purchasing
8 Citizens, that your company, UniSource, was interested
9 in purchasing Citizens' assets in the State of Arizona
10 prior to submitting the application or the first
11 document that opened the case. Had you called on the
12 phone or discussed that acquisition with members of the
13 Arizona Corporation Commission?

14 A. Yes, I met with each one of the
15 Commissioners personally to tell them that we were at
16 the final stages of making an agreement with Citizens to
17 acquire their properties, and I hoped that they would
18 view it favorably because we felt that we were trying to
19 correct a problem in the State of Arizona. We told them
20 that, how we would like to proceed, and we informed them
21 of what we were trying to do. I always sit down with
22 the Commissioners prior to us making a filing with the
23 Commission so that I don't inadvertently offend any
24 Commissioner or cause any problems with the Commission.

25 Q. That's fine.

1 Since you had already been in discussions
2 with the new investors with respect to your company, to
3 UniSource, prior to the Citizens acquisition, did you
4 mention that to any of the Commissioners at that time?

5 A. No, because I was in the process of
6 terminating those discussions relative to the investors.

7 Q. Okay. So the Commissioners only knew about
8 the Citizens acquisition at that time, and they did not
9 know that you had another possible arrangement and
10 discussions for that?

11 A. I had no other arrangement at that time.

12 Q. Okay.

13 A. And you have to realize that I have
14 considerable liability with the SEC, depending on
15 disclosures and inadvertent disclosures, and I have a
16 responsibility to the financial communities that I can
17 only give very limited information and only at an
18 appropriate time, and you have to understand the
19 tightrope that is continuously walked on this matter.

20 Q. I understand, and so far, it looks to me
21 like you've done it properly.

22 A. Thank you, sir.

23 Q. But maybe I shouldn't say that because I'm
24 not supposed to make comments, but I'm saying nothing
25 improper is a result so far of my questions. But I

1 wanted to get on the record that you have been proper,
2 because there is suspicion. That's fine.

3 Yesterday I had indicated some monies that I
4 thought people received that were board members of your
5 Staff, and it was revised from what I said in my opening
6 statement, and I will shift to the numbers that your
7 people had on their spreadsheet. And I assume that
8 spreadsheet was correct or was current or was a good
9 estimate of the approximate revenue, approximate value
10 of the stock that is being exercised.

11 A. Yes.

12 Q. But one question is when you listed the
13 names, did that also include members of the board of
14 directors and their exercising of their options in that
15 \$24 million?

16 A. No, it did not.

17 Q. Okay. So it does look like you're going to
18 receive some money to -- and will you still invest 5 or
19 so million dollars of the amount you will receive at the
20 completion of this event back into the new company?
21 That's your present plan?

22 A. Yes, sir. Yes, sir. And I've been very up
23 front on this. I called in a reporter, and I sat down
24 and I said, "I'm going to sell my existing stock and my
25 options, and the total proceeds will be 10 to

1 \$11 million pretax. I've made significant investments
2 in my money and time, and I'm going to reinvest the vast
3 majority of those after tax funds in the new entity."

4 Q. Thank you.

5 New subject: Do you remember in the fall
6 and winter of last year, there was a lot of discussion
7 in Congress on the National Energy Policy Act of 2003,
8 and during that discussion, did that have any influence
9 on any of your, on this particular acquisition?

10 A. No.

11 Q. Any of the items discussed?

12 A. No.

13 Q. And it had nothing that caused the timing of
14 any of the announcements?

15 A. No.

16 Q. What are the future long-term benefits that
17 you would see from the, that act -- did you do any
18 analysis on that act and how it might impact your
19 company?

20 A. Those acts have changed and they continue to
21 change. People that work for me evaluate them. Nothing
22 has come to enough concrete language that we have
23 evaluated to see --

24 Q. Have you noticed one item that seems to be
25 consistent in all the different versions of the act in

1 the last three or four years that involved revoking the
2 Public Utility Holding Company Act called PUHCA of 1935?
3 Have you noticed that that has been consistent in all
4 these versions?

5 A. It has been consistent for many years.

6 Q. Yes, for many years, people wanted to --
7 what would cancellation, the revoking of PUHCA, or the
8 Public Holding Utility Company Act of 1934, mean to this
9 acquisition?

10 A. I don't think it means much to this
11 acquisition, but a failure of this acquisition, revoking
12 PUHCA, would make UniSource a target of takeover by
13 other utilities. It would make it easier for other
14 utilities who feared the Public Utility Holding Company
15 Act or being a registered holding company, it would take
16 away that concern and would make it more likely that
17 another utility from Texas or from California or from
18 another state would look and covet this utility and
19 remove this utility from its local management, its local
20 Arizona presence.

21 Q. So did I understand correctly that revoking
22 PUHCA is not what you would recommend? You recommended
23 it stay intact?

24 A. I didn't make any recommendation. I just
25 told you that in my opinion, revoking PUHCA would cause

1 other large utilities out of state to get aggressive in
2 their mergers and acquisitions. That could be the
3 result of that.

4 Q. I like that answer. But unfortunately, it
5 looks like PUHCA might be revoked since it is
6 consistent, and if it is revoked in the future after
7 this acquisition, would you see it changing the
8 relationship between UniSource and the Corporation
9 Commission?

10 A. No. This acquisition actually will preserve
11 the relationship of UniSource with this Commission
12 because we have committed throughout this for the
13 continuation of the jurisdiction of this Commission and
14 we have given them 40 additional powers over this
15 company. Actually, this merger helps us maintain our
16 local presence and it helps this Corporation Commission
17 maintain and improve its oversight of this local
18 utility. Removal of PUHCA would put that at danger but
19 for this merger. That's what I've testified to.

20 Q. Okay. But you didn't testify with respect
21 to PUHCA, and I am just trying to say that the PUHCA
22 interference by its revoking, you have tried to counter
23 that with your 40 conditions?

24 A. I'm sorry, that's a non sequitur that I
25 don't --

1 Q. Not a good question.

2 A. -- I don't understand.

3 Q. Okay. I'll start again.

4 The 40 conditions that you proposed for this
5 acquisition would prevent some of the negative
6 consequences that revoking PUHCA would have?

7 A. That could result if PUHCA's revoked, and a
8 party other than this party came in to acquire
9 UniSource.

10 Q. Okay.

11 After, let's say PUHCA is, in a
12 hypothetical, let's say PUHCA is revoked, would Saguaro
13 Group I be able to expand and then go into additional
14 states?

15 A. Hypothetically, yes.

16 Q. Hypothetically, okay. If PUHCA is revoked,
17 would that have any impact on the reports and filings
18 that you would submit today to the ACC, FERC, IRS, and
19 Securities and Exchange Commission?

20 A. No.

21 Q. Okay.

22 You have also filed through the Federal
23 Energy Regulatory Commission in parallel to the filing
24 we are talking about today, is that correct?

25 A. That's correct.

1 Q. And does it contain a condition that is
2 requesting a waiver of PUHCA for one of the, for -- let
3 me start over again. Does it, does the agreement
4 between you and the investors require that a, that --
5 this is the wrong one, wrong data request. Let me start
6 over again.

7 I understand there's a condition with the
8 proposed purchasers of UniSource that if a certain
9 waiver is not obtained from the Federal Energy
10 Regulatory Commission, that this deal is off and would
11 not occur.

12 A. This transaction has to satisfy the
13 requirements of the federal law.

14 Q. I understand that.

15 A. I don't know if there's a waiver. It has to
16 be approved, so I don't know how to answer your
17 question.

18 Q. I thought I had the paper, but I don't have
19 it. But there was a data request on this subject, and
20 the answer to that data request was that if they did not
21 receive exactly what they wanted in their application,
22 then the investors would call the deal off.

23 A. I think you might want to ask the panel that
24 question.

25 Q. Okay.

1 A. This merger has to go, undergo federal
2 scrutiny, SEC scrutiny, and ACC scrutiny.

3 Q. And obviously, if they don't receive an
4 approval by FERC or by SEC, the deal is off?

5 A. That would be correct.

6 Q. The company has a very strong charity
7 program. What are the annual levels of cash and
8 non-cash values associated with this program for the
9 year 2003, approximately?

10 A. The, I believe that our total, if I
11 annualize UES Electric and Gas, is approximately between
12 600 and \$700,000, and our employees contribute about,
13 somewhere, about 27 to 30,000 hours of their time. I
14 don't have a value of that.

15 Q. I've seen some utilities that have issued a
16 report on their charitable contributions to the
17 community. Do you have such a report your company
18 routinely issues?

19 A. We have one that we put out that goes into
20 other programs that we do for the community indirectly,
21 environmental programs and things of that nature.

22 Q. Okay.

23 A. We can supply you one if you so desire.

24 Q. Appreciate it. Thank you.

25 One of the minor changes you did recently in

1 the 40 conditions involved the charities, and you
2 changed it from you were going to match the amount you
3 paid for 2003, then you changed the dates. Do you know
4 why that change was made?

5 A. I think they wanted an annual commitment.
6 It was because of a short, a stub period on UES Electric
7 and Gas, so they made it from the beginning --

8 Q. Okay.

9 A. -- where we acquired so that you got an
10 annual number.

11 Q. Okay. Thank you. I was, it was just a
12 minor change, but I just couldn't understand why you
13 would change those dates.

14 Who decides in your organization which
15 charities will receive this funding?

16 A. Mr. Lynn, Steve Lynn, is in charge of
17 charitable activities. I can tell you our general
18 policy is that we give to charities where our employees
19 are active. We will support those charities in those
20 communities that our employees feel are important to
21 their lifestyle in that community. That's the general
22 purpose. That's the general statement of our policy.

23 Q. And Mr. Lynn's job is what, sir?

24 A. He's vice-president of communications,
25 public relations.

1 Q. How are charitable contributions monitored?

2 A. I have a report provided to me.

3 Q. I have, for example, seen that the
4 Arizona-Mexican Commission meeting, that TEP was a
5 platinum or gold sponsor for hosting the meeting. Is
6 this a charity contribution, or is this an advertising
7 contribution, or how is that --

8 A. You know, I don't frankly know how that
9 particular one is classified. I don't know. I don't
10 think it's a charity.

11 Q. So probably it's not quite charity in that
12 sense, but it is obviously targeted to enhance the
13 reputation of your company?

14 A. It's partially targeted at that and
15 partially to help the State of Arizona in its
16 relationships.

17 Q. What is your approximate advertising budget?

18 A. I don't know.

19 Q. Will it stay approximately the same under
20 the new organization?

21 A. If I determine that it is appropriate, yes,
22 at my discretion.

23 Q. Can you personally submit a recommendation
24 that a charity be added to your list of charities?

25 A. Can I?

1 Q. Yes.

2 A. Yes.

3 Q. How many people in your company are involved
4 in charities?

5 A. I think --

6 Q. Managing the charities as an employee.

7 A. I don't think we have any employee that
8 manages a charity.

9 Q. Okay.

10 A. They will serve on the boards, they will
11 help to raise funds, they will be active in the
12 charities, and I think about a little over 50 percent of
13 our employees are active in charities.

14 Q. Have you personally ever donated to a
15 political action committee sponsored by your company?

16 A. No.

17 Q. How are donations collected for political
18 action committees managed by your company?

19 A. The company doesn't manage any political
20 action committees. Political action committees are
21 separate. I do not know who contributes to the
22 political action committees and I do not know how the
23 funds are distributed. I purposely do not undertake to
24 do that because political action committees are
25 voluntary contributions by employees, and I do not want

1 them to feel any pressure from me.

2 Q. Who manages that program?

3 A. It is conducted to my understanding by a
4 board established to utilize those. Our total, I asked
5 before I came, it's the only reason I know, our total
6 between state and federal political action committees is
7 somewhere between 5 and \$10,000 a year.

8 Q. Okay. Will you have political action
9 committees after the acquisition?

10 A. I would assume, yes.

11 Q. This is a local issue, but it involves
12 \$100,000. What organization provided a hundred thousand
13 dollars last year UES handed out at the Santa Cruz
14 County Board of Supervisors meeting to over 25 local
15 charities? Was this money from Citizens?

16 A. You know, I, that was part of the
17 negotiations. There had been, in my understanding,
18 there had been a dispute over street light revenues or
19 whatever, and it was determined, I think we got that
20 money back from Citizens and we made checks out to take
21 that money and put it to charities. I believe that's
22 how that transpired.

23 Q. The street lights from my viewpoint -- did
24 anybody talk about the fact that the City of Nogales and
25 the county had been double-charged for over 25 years for

1 street lights?

2 A. Sir, that's before my time. I'm not
3 double-charging anybody.

4 Q. I didn't say you.

5 A. I understand. I'm trying to be patient. We
6 gave the money, we took the money, we gave it to
7 charities.

8 Q. But that, what, as a citizen in this county
9 of Santa Cruz, that \$100,000 should have gone back to
10 our general fund. Would you agree that that's the
11 proper place for our funds?

12 A. I won't agree with that. That's your
13 opinion. We thought we did what was right.

14 Q. All right.

15 When your company furnishes lights for
16 baseball fields, where does that money come from?

17 A. That comes out of our charitable, I believe,
18 plus the time spent by our individual employees to put
19 it up, they do it on their own. We believe that youth
20 activities and safety in parks and lighting in parks and
21 enhancement to the community is an important function,
22 and yes, we put in lighting at a field in, soccer field
23 in Santa Cruz County because I thought it was the right
24 thing to do.

25 Q. Did you realize that the supervisor that

1 that county was, park was named after --

2 A. No, I did not realize that, but that
3 wouldn't change the fact that I thought it was right for
4 the children.

5 Q. Could you please explain your investment in
6 the Mexican coal mine and the associated CFE power
7 plant.

8 A. We have no investment in the CFE power
9 plant. Mr. Nitido as my general counsel negotiated a
10 transaction. I recused myself because I am on the board
11 of a Mexican steel company that owns 90 percent of the
12 coal properties in northern Mexico. Associated with
13 that coal is approximately 10 TCF of gas. We felt it
14 was a good investment to try to acquire a backup supply
15 of both coal and natural gas, and it was an investment
16 made by my investors, not by TEP or UES. It was an
17 investment made by UniSource.

18 Q. And has it made money?

19 A. No, and the ratepayer has not seen anything
20 on it and I imagine if it is very successful, the
21 ratepayer will see a tremendous benefit from it.

22 Q. Do you have any customers in Mexico that
23 want to purchase electricity from the transmission line,
24 your transmission line?

25 A. Yes, we do.

1 Q. Have you signed contracts with any of these
2 customers?

3 A. No, we haven't.

4 Q. Do you know if the Mexican environmental
5 impact statement for that transmission line has been
6 started in Mexico?

7 A. No, I do not know the answer to that.

8 Q. Have your new investors discussed your
9 relationships in Mexico during the, during the, this
10 phase of the program at all? Have they discussed your
11 investments in Mexico?

12 A. They are aware of them.

13 Q. New subject: During the last quarter,
14 UniSource had about nine-tenths of a million dollars
15 from --

16 A. Sir, can I interrupt you for a minute?

17 Q. Yes, sir.

18 A. Before you get off that, in your opening
19 statement, you used the term mordita. Here is the
20 company code of ethics which is signed by every employee
21 which specifically prohibits bribes of any sort and
22 specifically prohibits and indicates the Foreign Corrupt
23 Practices Act which covers that. Every employee signs
24 that. I sign an affidavit every year about any
25 conflicts that I have, and also that I subscribe to all

1 of these principles.

2 Q. Well, on that subject then, let me bring up,
3 do you have an ethics training program in your company?

4 A. I go out and speak to every employee at
5 least twice a year and stress ethics and fair dealing
6 and honesty --

7 Q. Okay.

8 A. -- because I have to sign every statement
9 that this company makes, and I'm responsible for all of
10 that.

11 Q. Good. Do you have an ethics, I'll use the
12 word we used, an ethics violation program where if any
13 employee is, somebody has tried to do something that is
14 unethical, that it gets reported on an 800 number? Is
15 that type of a program established inside your company?

16 A. Yes. It doesn't come to me. It goes to the
17 chairman of the audit committee.

18 Q. Yes, okay.

19 Let me go back to the new subject. During
20 the last quarter's statement, TEP had a net income of
21 approximately \$900,000. UES had a net income of
22 approximately \$4.9 million. Do you agree with those
23 statements? From your --

24 A. If you are reading from my -- they sound
25 approximately right.

1 Q. So just for that one quarter, and I know
2 it's an abnormal quarter compared to others in the year,
3 UES was your superstar in your company?

4 A. It performed right on the budget that we
5 anticipated. We're losing money at UES currently.
6 We'll start to pick it up again now as the summer is
7 here, and we anticipate that UES Electric and Gas, and
8 I've stated this on and on, would earn around
9 \$10 million in total for the year.

10 Q. New subject: You have new owners, or new
11 management coming into your company.

12 A. Don't have new management coming into this
13 company.

14 Q. Wrong word, new investors. Investors like
15 to make money. How do you see based on the various
16 options that they can make money, like increase rates,
17 lay off people, reduce charity contributions, change
18 benefits, and so forth, where do you think they're going
19 to target to earn more than you're earning today?

20 A. None of the areas that you cited are
21 targeted or will be targeted. You have my commitment,
22 and I'm running the company. I believe that they will
23 make their profit in this company by continuing to
24 increase its financial strength, by continuing to pay
25 down its debt, by continuing to have it grow profitably

1 with new construction, and they will make their money
2 when the market starts to value this company correctly.

3 We have talked in terms of premiums.

4 There's really no premium being paid here. These
5 investors are paying what they think the value of the
6 company is. There might be a short-term aberration,
7 there might be a long-term aberration in market
8 valuations. They value this company higher than the
9 marketplace. That's why it is a prudent purchase for
10 them. They don't have to cut our costs. They don't
11 have to cut programs. They don't have to increase
12 pricing.

13 Q. What is the principal source of revenue for
14 utility companies? Where does it come from?

15 A. The customer.

16 Q. The customer. And do you see that the
17 customer, at least through 2007, 8, will have no
18 changes?

19 A. If they use the same amount of electricity
20 tomorrow that they used today, they will have no change
21 in their prices.

22 Q. Do you have any forecast of what is going to
23 happen in 2007, 2008, with respect to the customers?

24 A. We are frozen to 2008.

25 Q. UES is 2007, TEP is 2008. That's why I'm

1 using two numbers.

2 A. I see. We've looked at various scenarios.
3 It really depends on the direction of the Commission.
4 Energy prices are trending upward. I'm not going to lie
5 to you. Gas, a lot of our base resource costs are going
6 up. It really ultimately depends on the Commission's
7 attitude to deregulation and how assets are treated
8 post-2008.

9 Q. Okay.

10 New subject, and I'd like to talk to the
11 Judge for just a second.

12 MR. MAGRUDER: What I have is a letter that
13 is in the docket from an employee of this, of TEP. This
14 letter that is in the docket, I have cut her name off
15 and covered it up so that I could hand it out to these
16 people so that that person who -- this is a negative
17 letter -- would not have a problem. But the letter is
18 also in the docket, and I can hand it out with the name
19 on it.

20 ALJ RODDA: I don't care. It's part of the
21 public record.

22 MR. MAGRUDER: It is part of the public
23 record. I would just like to talk about that letter and
24 enter it as possibly Magruder Exhibit 1.

25 MR. HEYMAN: Your Honor, I don't have an

1 objection to the exhibit. We have looked at everything
2 that is in the docket.

3 I would like to go on the record and just
4 object to the inference there that because somebody who
5 is an employee may have a negative attitude towards the
6 merger that there would be some retaliation or that
7 there would be a negative connotation with the company.
8 And if that would be retracted, I will retract my
9 objection.

10 MR. MAGRUDER: I will retract it because I
11 am concerned about that employee, and I appreciate your
12 comments, and that is the proper attitude you should
13 have.

14 MR. HEYMAN: Thank you.

15 MR. MAGRUDER: Can I hand out the letter?

16 ALJ RODDA: Yes, sir.

17 MR. MAGRUDER: Do you want the redacted one?

18 MR. HEYMAN: Whichever you want to put in.

19 COMMISSIONER MUNDELL: Judge, so it's clear,
20 Mr. Heyman, you know, in other cases and other examples,
21 historically, there have been retaliations of employees
22 who have spoken out against corporations. So just so
23 the record is clear, you are stating on the record not
24 the inference that Mr. Magruder made, but there will be
25 no retaliation against this employee by the company or

1 the future investors?

2 MR. HEYMAN: I will put that statement on
3 the record. The other thing I want to clarify is this
4 is a man, not a woman.

5 COMMISSIONER MUNDELL: I think I said
6 employee.

7 MR. HEYMAN: Mr. Magruder said that. And
8 yes, this is a letter that everybody is aware of, and it
9 is a representation that the company is happy to make.

10 COMMISSIONER MUNDELL: Thank you.

11 ALJ RODDA: Mr. Magruder, before you start
12 on this letter, do you have many more subject changes, I
13 mean, new subjects?

14 MR. MAGRUDER: No, this is almost the last
15 major subject I am talking about.

16 ALJ RODDA: Well, I'm just -- are you a
17 lawyer or what? I just -- it's time -- I'm sorry,
18 Mr. Heyman?

19 MR. MAGRUDER: I am on question 82, and I
20 have 98.

21 ALJ RODDA: Okay. We will try to get
22 through Mr. Magruder before the break.

23 MR. MAGRUDER: And most of the questions
24 have to do with the letter which might be fast.

25 Q. (BY MR. MAGRUDER) Let me establish the

1 basis for the letter, and then, or the basis of my
2 request, and then ask some questions, then I will see if
3 I can get it entered into the record. This letter is
4 from a 31-year employee which was received into the
5 docket on 19 May. I provided a copy to all parties
6 present, and since obviously -- no, this letter was
7 first located at Docket Control when I was apprised of
8 this letter. When I reviewed it -- and I've submitted
9 it to be Magruder Exhibit 1. It's -- and I'd like to
10 have Mr. Pignatelli take a look at it.

11 A. I've looked at it.

12 Q. Okay. It says that Mr. Pignatelli requested
13 that the union head send a supporting letter to the
14 Corporation Commission. Did you do that, sir?

15 A. Yes, I did.

16 Q. Okay. The letter said that there are no
17 guarantees about the existing and future management of
18 the status quo that will remain for the personnel in the
19 company. Is that true?

20 A. That's incorrect.

21 Q. And how would you respond to that?

22 A. I have told all the employees, in fact, I
23 have met with all of them when this transaction was
24 announced and said that all union agreements would be
25 honored, all management, current management would stay

1 in place, all pensions and benefits would be honored.

2 I'm interested, this is very interesting to me, because
3 if I only have one employee out of 1,500 that is upset
4 with me, I must be doing something wrong.

5 Q. Well, this indicates that, this letter
6 indicates that every department in TEP is currently
7 short-handed.

8 A. That's certainly that person's opinion, but
9 I will rest our performance on the safe and reliable
10 service which we provide. I continue to put pressure on
11 this company, because that's my obligation to you as a
12 consumer. You wouldn't want me to have 5,000 employees
13 charging and supplying you power. I am running this
14 company as efficiently as possible. This is one person
15 out of 1,500's opinion.

16 Q. I understand, but let me talk about the
17 substation department. It now has fewer than 30
18 employees when it once had over 40. Why would that
19 department have 25 percent less employees now?

20 A. Because we operate with more automation in
21 our system.

22 Q. Okay.

23 A. Our substations run fine with the number of
24 people that are there. We have automated -- we have
25 attempted to be as efficient as possible.

1 Q. Okay. There are over 100, there were at one
2 time over 100 journeymen in the line construction
3 department. Now that entire department which includes
4 all people is less than 90.

5 A. And we have apprenticeship programs in
6 place. We are concerned about the future linemen. It
7 takes us five years to train a lineman. We have
8 apprenticeship programs in place. We have hundreds of
9 thousands of dollars invested in every lineman and
10 believe we, we look at our, the average age of our
11 employee, and we're very responsive to getting programs
12 in place to insure continuity.

13 Q. Do you agree with this letter comment that
14 approximately 40 percent of TEP employees will be
15 eligible for retirement in the next three years?

16 A. I don't know if that, that number is a
17 little bit high, but we have a significant amount of
18 people that are subject to the rule of 85 and are
19 eligible to retire. At this point in time, most of the
20 ones that reach the rule of 85 are choosing to stay
21 longer. But yes, it is a concern of mine, but I have
22 these concerns every day.

23 Q. Okay. This person is concerned, too.

24 A. Well, I'm glad he is.

25 Q. Do you agree that there's severe shortage of

1 personnel, severe shortages of personnel, if they exist
2 in your company, would they cause problems with safety
3 and reliability?

4 A. If there are severe shortages, they could --

5 Q. Okay. That's my question.

6 A. -- but there are not severe shortages.

7 Q. Okay. Are you short in any of your
8 departments?

9 A. I am sure there are places that are being
10 filled today.

11 Q. Okay. The employee is also concerned about
12 lack of information on retirement rules, will there be
13 early buyouts, and they've received no information. Has
14 there been a program underway since the announcement of
15 this acquisition to keep employees informed on
16 retirement and similar type programs?

17 A. I'm not changing any of their existing
18 retirements, and no, there is not going to be an early
19 buyout. Why would I have an early buyout if I have
20 shortages?

21 Q. I don't think an early buyout would be a
22 good idea either.

23 A. Thank you.

24 Q. Therefore, I have completed this exhibit.

25 MR. MAGRUDER: I move Magruder Exhibit 1 be

1 entered into the record.

2 ALJ RODDA: Any objection to Magruder 1?

3 Then Magruder 1 is admitted.

4 Q. (BY MR. MAGRUDER) On the subject of one and
5 a half billion dollars you mentioned yesterday that you
6 were going to put into O & M and capital spending,
7 looking at the last quarter's TEP sales, they increased
8 by 10 percent. If we had 10 percent increase every year
9 for the next four years, maybe the 10 percent above the
10 recommended value which total 1.5 billion might not be
11 enough?

12 A. We will make what is necessary to maintain
13 safe and reliable service. Our sales were up because we
14 had an unusual cold snap this year.

15 Q. Okay.

16 A. That's why the sales were up. You have to
17 be very careful when you compare period to period,
18 because you have to understand what happened in the
19 prior period that you're comparing it to and what the
20 circumstances of that period were.

21 Q. So your one and a half billion takes into
22 account future growth?

23 A. Yes, sir.

24 Q. Looking at longer term thinking, is your
25 company possibly moving towards what some people talked

1 about, distributed generation, renewable energy, and
2 local power plants?

3 A. All of the above. I've always been an
4 advocate of distributed generation when it can be done
5 environmentally, consistent with the environment. I've
6 always been an advocate of renewables, and yes, we will
7 look at other local generation because of the difficulty
8 in siting transmission.

9 Q. Good.

10 Are you in favor of increasing the
11 1.1 percent environmental portfolio standard that is
12 being discussed at the Corporation Commission?

13 A. Frankly, no, because I think it's too
14 expensive for the consumer.

15 Q. Okay. I have a request, and I'll ask it as
16 a question. Since your symbol UNS will disappear after
17 this company, if this is approved --

18 A. I disagree with your statement.

19 Q. It will disappear on the stock market, won't
20 it?

21 A. Yes, but it will still appear on our trucks.

22 Q. Okay. It will still appear on your trucks,
23 UNS. I was just thinking maybe you could make the two
24 subsidiaries, UNS Electric and UNS Gas, would it be
25 better if they were called UniSource Electric and

1 UniSource Gas as people have referred to in these
2 hearings? No decision, just a suggestion.

3 A. I will take your suggestion under
4 advisement.

5 Q. Because I think it would give a better
6 branding name to the utilities that I particularly
7 participate in --

8 A. Okay. Thank you.

9 Q. -- from a branding sense.

10 A. Thank you for your suggestion.

11 MR. MAGRUDER: That's all my questions,
12 Mr. Pignatelli. Thank you very much.

13 THE WITNESS: I have just one question I
14 would like to ask.

15 MR. HEYMAN: Can I object to my own witness?
16 We'll get that on redirect.

17 ALJ RODDA: Okay. Let's take a ten-minute
18 break.

19 (A recess ensued.)

20 (Commissioner Hatch-Miller enters the
21 proceedings.)

22 ALJ RODDA: Okay. We're back live, and
23 Mr. Enoch, I believe you have some questions for
24 Mr. Pignatelli.

25 MR. ENOCH: Thank you, Your Honor.

1 CROSS-EXAMINATION

2

3 Q. (BY MR. ENOCH) Good morning,
4 Mr. Pignatelli. Again, my name is Nicholas Enoch. I'm
5 the attorney for Locals 387 and 769 of the International
6 Brotherhood of Electrical Workers. I have a few brief
7 questions for you this morning.

8 A. Yes, sir.

9 Q. I don't believe it's in the record other
10 than my opening statement, and I don't think that
11 counts, so can you tell me how many collective
12 bargaining units UniSource is currently a signatory to?

13 A. We have collective bargaining agreements
14 with Local 1116. We have a collective bargaining
15 agreement with the union that represents the Santa Cruz
16 employees, I think that's 387, and we have collective
17 bargaining agreements being negotiated at the electric
18 and gas entities. They're under negotiations, but I
19 don't know if those agreements are complete. And I
20 think, we used to have a separate agreement with the
21 Springerville employees, but that might have been under
22 the 1116 at this point in time.

23 Q. The one you said is currently being
24 negotiated, do you know if that is Local 769 of the
25 International Brotherhood of Electrical Workers?

1 A. I am sorry, I don't know the number. I
2 would accept that, subject to verification.

3 Q. Okay. The Santa Cruz unit which I believe
4 you testified was Local 387, how long has that been a
5 unit underneath UniSource?

6 A. Since August the 16th of last year.

7 Q. And that was due to the merger with
8 Citizens?

9 A. The acquisition of the Citizens assets, yes,
10 sir.

11 Q. And do you know, if you know, do you know
12 how long Local 387 has had a collective bargaining
13 agreement with Citizens going back in time?

14 A. No, I am not aware of that.

15 Q. The nature of the relationship of Local 769
16 which is the gas and electric that you testified about
17 before, do you know how long UniSource has had a
18 relationship with that local?

19 A. Some of those employees were represented
20 when we acquired the company on August 16th. And there
21 was an organization vote which brought additional
22 employees into that, so I would say that we've had the
23 relationship since August 16th, but it has been extended
24 to cover additional employees more recently than that.

25 Q. And those employees are mostly in Mohave

1 County, is that correct?

2 A. That's correct.

3 Q. And if you know, do you know how long
4 Local 769 has represented basically that group of
5 employees?

6 A. No, I do not.

7 Q. Okay. And the third local that you
8 testified about, 1116, who does that local represent?

9 A. It represents all of our, all of our
10 electrical employees, a good portion of our office
11 employees, as well as all of our Springerville
12 employees.

13 Q. And are those the employees with Tucson
14 Electric?

15 A. Yes, sir.

16 Q. And do you know how long Local 1116 has had
17 a relationship with Tucson Electric?

18 A. Many, many years. It goes back way before I
19 arrived here.

20 Q. And what year was that?

21 A. I arrived here in 1994.

22 Q. Is it safe to say several decades before
23 that?

24 A. Yes.

25 Q. How would you describe UniSource's

1 relationship with these three unions?

2 A. I would describe our relationships with the
3 unions as very positive. We have been negotiating under
4 mutual gains and for a long period of time, and we have
5 excellent relationships with our union employees.

6 Q. Do you believe that UniSource's, using your
7 word, excellent relationship with these three unions
8 ultimately enures to the benefit of the shareholders of
9 UniSource?

10 A. I think it enures to the shareholders and to
11 the customers of UniSource and its jurisdiction
12 utilities.

13 Q. Can you describe to me how UniSource's
14 excellent relationship with its labor unions impacts its
15 ability to provide safe, reasonable, and adequate
16 service to the patrons of UniSource?

17 A. I believe that a good working environment is
18 my responsibility to provide to the employees, and a
19 good relationship with the employees, union and
20 nonrepresented, is essential to the maintenance of safe,
21 reliable service.

22 Q. Would you agree with the notion that
23 acrimonious relations between a public utility and a
24 labor organization certified to provide services for the
25 customers of that public utility could very well impair

1 the ability of the utility to provide safe, reasonable
2 and adequate service?

3 A. Yes.

4 Q. Would you agree with the notion that
5 acrimonious relations between a public utility and the
6 labor organization certified to provide services for the
7 customers of that public utility could prevent the
8 public utility from attracting capital at fair and
9 reasonable terms?

10 A. Prevent might be a little harsh, but it
11 would certainly make it much more difficult.

12 Q. Do you know the extent to which your
13 nonmanagerial employees are themselves shareholders of
14 UniSource?

15 A. I don't keep track of that. I have always
16 encouraged all of my employees to invest in the company
17 that they work for. Unfortunately, there was a little
18 issue before I came with the freezing of a 401 plan, and
19 some of the employees lost money in that, and there was
20 reluctance on the behalf of many, especially the rank
21 and file, to invest in the company. But I have
22 steadfastly encouraged their investment in the company,
23 and, you know, one of the interesting things that has
24 come out of me going around and talking to all the
25 employees about this transaction is the vast number of

1 employees, both from new employees from the old Citizens
2 and many of them represented employees, who indicated
3 desire to be able to invest in the new company. So I
4 think that there is, has been an increase in the
5 ownership in the employee base.

6 Q. So it's fair to say that the employees are
7 in a sense a stakeholder, aside from their employment,
8 but also as shareholders, correct?

9 A. Yes, there would be some --

10 MR. ENOCH: Thank you. That's all.

11 THE WITNESS: -- including me.

12 MR. ENOCH: Thank you.

13 THE WITNESS: Yes, sir.

14 ALJ RODDA: Thank you, Mr. Enoch.

15 Mr. Robertson.

16 MR. ROBERTSON: Thank you, Your Honor,
17 members of the Commission.

18

19 CROSS-EXAMINATION

20

21 Q. (BY MR. ROBERTSON) Good morning,
22 Mr. Pignatelli. How are you?

23 A. I'm fine, sir. Thank you.

24 Q. Nice to see you again.

25 A number of the questions I'm going to be

1 asking you today relate directly to either the direct
2 testimony or the rebuttal testimony that you filed in
3 this proceeding. Do you have copies of those two
4 documents with you?

5 A. Yes, I do.

6 Q. Okay. Before I start with those, I did want
7 to address before I forget two areas that came up during
8 the course of Mr. Magruder's questioning of you this
9 morning. You indicated at one time in one of your
10 responses if I heard you correctly that Tucson Electric
11 Power Company's current power generation resources is
12 approximately 90 percent coal fire. Did I hear you
13 correctly?

14 A. I said that approximately 90 percent of the
15 energy that we sell comes from coal. We have a higher
16 percentage of, if you look at capacity, we have more,
17 less coal than 90 percent, but of the energy we sell,
18 about 90 percent comes from coal.

19 Q. Okay. What would be the nature of the other
20 power resources that the company has at the present
21 time?

22 A. Gas and purchased power from other entities.

23 Q. So it would be coal fired, natural gas, and
24 purchased power?

25 A. Yes, sir.

1 Q. Okay. Now, you also indicated in response
2 to another line of questioning from Mr. Magruder that
3 you personally believe there was a definite role for
4 both distributed generation and renewable energy
5 sources, is that correct?

6 A. That's correct, sir.

7 Q. Okay.

8 A. Sir, on the 90 percent, that's TEP. We
9 acquire all of our energy for UES Electric from third
10 parties, just so that we're clear.

11 Q. I was familiar with that, and that's why I
12 didn't ask you about that.

13 A. Okay.

14 Q. You also indicated during the course of
15 Mr. Magruder's examination of you that you had recently
16 had a three-day meeting, if I understood you correctly,
17 with the members of the board of directors discussing
18 energy resources and power resources for the future for
19 the company, is that correct?

20 A. That's correct, sir.

21 Q. Now, which board of directors was that?

22 A. The only one I have.

23 Q. Okay.

24 A. My existing board of directors.

25 Q. That would be for UniSource, correct?

1 A. Yes, and TEP which is an overlapping board.

2 Q. Okay. In that regard, was there any
3 discussion of the company's approach on power resources
4 for the future, looking into whatever period you
5 addressed during the meeting?

6 A. Yes, sir. We see the immediate states in a
7 little bit of a power over-supply for the next six or
8 seven years, and then the, coming back into equilibrium,
9 and we have a need for approximately 300, let's say
10 400 megawatts to cover peak at UES Electric, and we're
11 adding about 50 megawatts of demand a year. So I see
12 that in the next five to seven years, I'm going to have
13 to plan for additional power resources or continue to
14 acquire it on the market. And that really becomes, and
15 what we were discussing is the interplay with where
16 regulation is going or isn't going and how that has to
17 impact our needs to continue to supply safe and reliable
18 electricity to our customers.

19 Q. As you look forward into the future for the
20 electric operations of your companies, and for
21 simplicity, I will refer to it in the plural instead of
22 saying TEP and UNS from time to time, what is your view
23 of what would be an appropriate balance in your
24 portfolio of power resources?

25 A. I, I've always felt that at a minimum, so

1 that I can somewhat contain costs, that the company
2 should have ownership of at least 75 percent of its
3 total energy needs and not to put itself on the market
4 for more than 25 percent or so. I have felt that coal
5 and nuclear are the appropriate resources, that gas is
6 too variable a resource at the present time and trending
7 higher, puts too much upward pressure on consumers. I
8 guess that summarizes where my head is.

9 Q. How do distributed generation and renewables
10 fit into a balanced portfolio of resources?

11 A. Distributed generation I think is a little
12 expensive at this point in time. If it's appropriate, I
13 certainly would look at it. I've always had a little
14 bit of difficulty with distributed generation because
15 you're dealing with smaller and smaller units, less and
16 less emissions control and are not as efficient in
17 consumption of base energy. So you have a tendency to
18 put a little more negative impact on the environment.
19 But I certainly, if it was a fuel cell or something of
20 that nature that could come into being that wasn't
21 driven too much by variable gas cost, I would certainly
22 look at that.

23 Renewables I have always been a proponent
24 of. I have always been a proponent of solar. I just
25 have to caveat that they are expensive, and we have to

1 work them into the blend in an appropriate manner for
2 the consumer.

3 Q. In the case of distributed generation, if it
4 were, for example, a customer-owned facility, what would
5 be the criteria you would look at in determining whether
6 it was appropriate, to use your word?

7 A. We have in general worked with our customers
8 when they have put in their own generation. If I depend
9 upon it for my load, it has to meet certain reliability
10 characteristics. If the particular customer wants to go
11 off of our system but depend upon backup from us, then
12 we have rates which provide for that which are all
13 approved by the Commission.

14 I am not negative to self-generation, but I
15 am the provider of last resort, and as long as I have
16 the obligation to all those customers, I really like to
17 see what they're putting in, because ultimately, if it
18 fails, they depend upon me or the company. So I
19 approach it carefully, but we certainly have never tried
20 to block it or discourage it. We have worked with
21 customers, we have told them that it didn't make sense
22 in many cases, and some of them went on and did it. Our
23 recommendation has proven that it didn't make sense, but
24 we're cooperative in that regard.

25 Q. I gather from both the content and the tone

1 of your response that you are definitely willing to work
2 with customers in exploring distributed generation and
3 when and where it might not be appropriate. Is that
4 correct?

5 A. I will work with any customer on that, yes.

6 Q. Okay. Does Tucson Electric Power have any
7 distributed generation facilities in its service area at
8 the present time that are customer owned?

9 A. Well, we have solar facilities that are
10 somewhat distributed in some cases. The University of
11 Arizona has its own generation, or it, it has about
12 10 megawatts of generation. There's a small, small
13 installation at the city, and there was a small
14 installation at a car wash, as I recall, in, Sahuarita
15 or down in Green Valley. We don't have a lot.
16 Distributed generation in my opinion is still a little
17 expensive, so people are looking at more cogent
18 applications, and we frankly don't have a lot of
19 balanced heat energy customers.

20 Q. Okay. And how about renewables? Any
21 active renewables activity as a part of your company's
22 resources mix?

23 A. We have solar, and we have methane gas we
24 cover. We don't have any, but I would love to have some
25 hydro.

1 Q. And are the solar and methane you referred
2 to the ones that I believe you described in your direct
3 prefiled testimony?

4 A. Yes, sir.

5 Q. Okay.

6 At your recent meeting with the board of
7 directors, did you have occasion during your discussion
8 of power resources and looking forward to include
9 discussion of distributed generation or renewables as a
10 part of the resource portfolio looking forward?

11 A. No, we did not.

12 Q. Okay.

13 One last point in this area, and it was
14 towards the end of his examination of you, I believe in
15 response to a question from Mr. Magruder, you expressed
16 the opinion that you felt that the one percent EPS was
17 too expensive. Could you elaborate on your thought
18 process behind that conclusion?

19 MR. HEYMAN: Can you repeat it? I don't
20 think he heard you.

21 MR. ROBERTSON: I'm sorry. I'm being told
22 you didn't hear me or the court reporter didn't hear me.

23 THE COURT REPORTER: I heard the question.
24 I can read it back if you would like.

25 Q. (BY MR. ROBERTSON) Would you like it read

1 back?

2 A. No, I think I understand the question. I
3 don't think I said one, I think it was 1.1 percent, but
4 I didn't say it was too expensive. I said to increase
5 it, I meant to say if I didn't say it this way to
6 increase it we should be careful because the cost of
7 renewables is generally higher than our current cost of
8 generation and it will put upward pressure on consumer
9 prices. I think we should do everything possible to
10 encourage renewable, but only adopt a firm renewable
11 program when we fully understand the impact on the
12 customer.

13 Q. Do you personally know what views the
14 investors may or may not have? And as I use the term
15 investors, it's as been defined in the prefiled
16 testimony, with regard to the subject of renewables.

17 A. No, I don't.

18 Q. Do you personally know what opinions, if
19 any, they may have with regard to the subject of
20 distributed generation?

21 A. No, I don't know if they have investments in
22 distributed generation. I don't know their attitudes
23 toward that.

24 Q. The same question with regard to either
25 energy efficiency or demand side management.

1 A. No, I don't think, I don't know their
2 opinions on those.

3 Q. Okay.

4 Let's shift topics. I'm going to go to a
5 statement that you make on page 28 of your direct
6 testimony, and it relates to an area that Mr. Magruder
7 was exploring with you. And starting on line 12,
8 continuing through line 15, you make the following
9 statement: "And as the Commission is aware, TEP is
10 meeting with various federal agencies in order to secure
11 approvals, permits, and rights of way to build a
12 transmission line. When constructed, this transmission
13 line will enhance reliability and import capacity to
14 southern Arizona."

15 Now, the line we are talking about here
16 would be the one that would run from the Tucson area
17 down to the Mexican border, is that correct?

18 A. That's correct, sir.

19 Q. Let me ask you, what approvals are necessary
20 on the Mexican side of the border before you could begin
21 to either export power to Mexico or import power coming
22 from Mexico?

23 A. The only approval I am aware of would be an
24 Interconnection Agreement between us and CFE.

25 Q. And that is the only --

1 A. That's on the Mexican side.

2 Q. That's the only approval that would be
3 required?

4 A. In Mexico.

5 Q. Okay.

6 A. That's to my understanding.

7 Q. Have you received any opinions from the
8 company's attorneys as to whether or not under existing
9 Mexican law you would be able to import electricity into
10 Mexico from a power plant that is located in the United
11 States?

12 A. I haven't received any opinion from my
13 counsel.

14 Q. Do you have an opinion yourself?

15 A. Yes. Power with a presidential permit can
16 be exported from the United States or imported into
17 Mexico. It's done every day at Juarez.

18 Q. That's the U.S. side of the transaction. I
19 may have been imprecise in framing the question. The
20 question went to the Mexican side of the border. Aside
21 from the Interconnection Agreement with CFE, do you know
22 whether under existing Mexican law it is legal for CFE
23 to purchase electricity imported from a power plant
24 located in the United States?

25 A. I believe it is legal for them to do that.

1 That's what they're doing in Juarez. CFE is buying from
2 power plants in the United States, taking it across to
3 supply needs in Juarez.

4 Q. Would I be safe in assuming you would not
5 begin construction on the 345 kV line until you had
6 satisfied yourself that all necessary legal approvals
7 and permits and contractual arrangements had been
8 obtained on both sides of the border?

9 A. Yes, you would be safe in assuming that.

10 Q. In the event for some reason a necessary
11 permit or contractual arrangement should prove to be not
12 forthcoming on the Mexican side of the border, would the
13 company still build the line?

14 A. It would depend upon the growth in southern
15 Arizona. The current growth in southern Arizona does
16 not justify that size of a line. We have committed to
17 improve the reliability and maintain the improved
18 reliability in southern Arizona, and there needs to be
19 some additional provision for those customers.

20 There are only a limited amount of
21 transmission lines that are going to be sited and
22 permitted, and I always feel that it is, we're going to
23 injure somebody in the future if we undersize a
24 transmission line when we initially build it because you
25 will never go back and rebuild them. As a financial

1 matter, though, I would have a hard time justifying that
2 level of expenditure just to backbone Santa Cruz County.

3 Q. Even though I live in Santa Cruz County and
4 would benefit from a 345 kV, I would have to agree with
5 you.

6 Would a 115 kV line be appropriate in order
7 to avoid the undersizing problem in the event the
8 necessary approvals on the Mexican side should not be
9 forthcoming?

10 MR. HEYMAN: Excuse me, Your Honor. I want
11 to impose the same objection I did with Mr. Magruder.
12 I've let Mr. Robertson ask a number of these questions,
13 but they have not yet been tied to whether the merger
14 would have an impact on any of this or how it would be
15 affected by the merger, so unless we can tie it back to
16 the merger, I would ask that we move on to another area.

17 MR. ROBERTSON: Your Honor, in response, I
18 will return to page 28 of Mr. Pignatelli's direct
19 testimony where he is talking about the transmission
20 line in question, and when constructed, this
21 transmission line will enhance reliability and import
22 capacity to southern Arizona. We are talking about the
23 reliability point in the event the reason for importing
24 is not available under the hypothetical I asked him to
25 assume for purposes of my questions. He had indicated

1 he would want to avoid undersizing. I was simply trying
2 to find out in his opinion if it's not the 345 kV which
3 he indicated he could not recommend be constructed what
4 it might be. And that's really the end of my inquiry,
5 but I think it's very logically related to the witness's
6 testimony.

7 ALJ RODDA: Well, it, being that that is the
8 end of the inquiry, that sort of solves the problem.

9 MR. HEYMAN: That was going to be my point
10 as well. Thank you.

11 ALJ RODDA: I assume you will in argument or
12 whatever tie it into the merger and how that impacts any
13 decision, because they have the same issue pre or post.

14 MR. ROBERTSON: I didn't mean to interrupt,
15 Your Honor. Let me respond to that very briefly. I
16 would anticipate and assume the amount budgeted for this
17 line or whatever amount is spent is part of the 1.5
18 billion that the witness has testified to elsewhere will
19 be expended over the next five years.

20 ALJ RODDA: I think that is a good question.

21 MR. HEYMAN: I think that's a great
22 question.

23 Q. (BY MR. ROBERTSON) Well, is my assumption
24 in that regard correct or not?

25 A. You are incorrect in your assumption. That

1 line is not included in the 1.5.

2 Q. Okay.

3 MR. ROBERTSON: If I could go back to the
4 other point, if I have your leave to finish off with one
5 question.

6 ALJ RODDA: Yes, please.

7 Q. (BY MR. ROBERTSON) Would a 115 kV line be
8 an appropriate size in your opinion?

9 A. In my opinion as an attorney and not an
10 engineer, I would have to turn it over to my system
11 planners and say how long would this support us.
12 Because of the problems with transmission, I am really
13 loathe to undersize something because growth will catch
14 my successor, and if I've undersized something and they
15 then have problems, somebody at this Commission is going
16 to be very anxious about me and my successor. I don't
17 know if a 115 is adequate. I just don't know.

18 Q. And as a fellow lawyer, Mr. Pignatelli, I
19 don't either.

20 Let's go to your rebuttal testimony, and for
21 your convenience, with each of my questions, I will try
22 to give you a page number reference and also the lines
23 of the testimony. And I begin by looking at the portion
24 of your response or your testimony that begins towards
25 the bottom of page 8 where you're talking about the

1 Affiliated Interest Rules and continues over onto the
2 top of page 9 through line 6, and again, that portion of
3 your response on page 9 beginning at line 13 and
4 continuing through line 18. If you would like to take a
5 moment to look at that.

6 A. I missed the beginning of that last --

7 Q. Oh, the first part was on the bottom of
8 page 8, beginning several lines up where you are
9 discussing the Affiliated Interest Rule at the
10 Commission, then continuing over on the top of page 9
11 through line 6, and then resuming on page 9 at line 13
12 through line 18.

13 A. Okay.

14 Q. Against the background of that part of your
15 testimony, sir, in your opinion, do the Commission's
16 Affiliated Interest Rules authorize the Commission to
17 stop or alter the impending reorganization?

18 A. I believe that the Commission's affiliate
19 transaction rules as indicated here provide a no harm
20 test that this merger should be evaluated against. In
21 light of the desire of some parties to extend the no
22 harm case test, we have pro-offered what we believe are
23 significant advantages to demonstrate that this merger
24 is in the public interest. Under a strict reading of
25 the affiliate transaction rules, I believe that we have

1 carried our burden with these conditions and with the
2 existing powers of this Commission to satisfy the no
3 harm test, and I believe that we have demonstrated
4 sufficient benefits to satisfy the public interest test.
5 I don't know if I answered your question, but I tried
6 to.

7 Q. No, I appreciate your response. Let me
8 reframe my question in light of your response.

9 If we will assume for purposes of my inquiry
10 that the Commission should determine under the No-Harm
11 Rule that's posted on the board there that those three
12 criteria identified in that rule have been satisfied,
13 but that for other reasons, it believes approval of the
14 proposed acquisition and reorganization would not be
15 appropriate and would not be in the public interest, do
16 you believe that it has the authority to reject the
17 proposed acquisition on that ground?

18 A. On grounds other than the no harm?

19 Q. Yes, sir.

20 A. I frankly don't.

21 Q. Okay. You indicated a moment ago in a
22 response that you're an attorney. Have you any
23 awareness as to whether or not there's any case law to
24 support your belief that the Commission does not have
25 the authority to reject the proposal on a public

1 interest ground, assuming the three criteria set forth
2 in the No-Harm Rule have been satisfied?

3 A. I believe there is case law that says the
4 specific language included in the affiliate transaction
5 rules is within the purview of the Commission under
6 their broad arching public interest criteria, and their
7 interest in, I'm trying to think of the term, I forget
8 the term that's in the Constitution, but that those
9 provisions in the authority in the Constitution mandated
10 to the Commission authorize the Commission to establish
11 specific rules which pertain to non-jurisdictional
12 companies that have affiliations with jurisdictional
13 companies, and that these rules as adopted are
14 authorized under those broader powers of the Commission.
15 But once adopted, I really believe that the specific
16 statutory language generally provides the test that
17 should be applied over the general operative authorizing
18 language.

19 Q. In your response, you just used the word
20 statutory. When you used that word, were you referring
21 to Arizona Administrative Code R14-2-803.C?

22 A. Yes, sir.

23 Q. Okay. Which that technically is a
24 regulation, but that is what you were referring to?

25 A. Yes, sir.

1 Q. Okay. For purposes of my question, if we
2 can assume that the company's evidentiary presentation
3 satisfies the three criteria that are set forth in that
4 regulation, are you aware of any Arizona case law that
5 says under those circumstances, the Commission must
6 approve the proposal before it?

7 A. No, I'm not aware of any case that says the
8 Commission can't in its deliberation consider other
9 things. I'm just saying that this law in my opinion
10 sets forth the threshold, and I think we have sustained
11 that threshold and proven more because this transaction
12 is so important to the state.

13 Q. I understand that, but if in considering
14 other things, the Commission should decide that despite
15 having satisfied these criteria, the transaction should
16 not be approved, do you believe it would be acting
17 erroneously, as a legal matter?

18 MR. HEYMAN: At that point, I will interpose
19 an objection on two grounds. Number one, we've explored
20 a little bit the extent of Mr. Pignatelli's knowledge of
21 the area. He indicated in response to a question about
22 was he aware of any precedent citations, so I think we
23 are asking him now to reach the legal conclusion.

24 Second concern, quite frankly, is if
25 Mr. Pignatelli keeps giving legal opinions, he is not

1 going to need me, and so I would like to cut it off at
2 this point.

3 MR. ROBERTSON: Well, if I might respond
4 very briefly, Your Honor, Mr. Pignatelli identified
5 himself as an attorney. He's a very able attorney, and
6 obviously a highly intelligent individual. And I have
7 been very careful in phrasing my questions, were they
8 his opinion, was he aware of any cases, and I at one
9 point had asked him in a different area had he received
10 any advice from the company's attorneys, because I
11 anticipated Mr. Heyman might at one point or another
12 impose an objection, and I wanted to anticipate his
13 grounds for it as much as possible. The second ground
14 for Mr. Heyman's objection, I can't really do much about
15 that.

16 ALJ RODDA: And, well, I don't think he's
17 testifying here as an attorney, but --

18 MR. HEYMAN: Your Honor, if I might, I want
19 to put on the record that he is not licensed to practice
20 in Arizona nor is he representing the company as an
21 attorney in this proceeding. So with that
22 qualification, he's in essence giving a layman's opinion
23 on a legal matter.

24 ALJ RODDA: Right. And now I've forgotten
25 the question, so can you read back the last question?

1 (The record was read by the reporter as
2 requested.)

3 MR. ROBERTSON: Let me rephrase the
4 question.

5 ALJ RODDA: If you didn't put that "as a
6 legal matter."

7 Q. (BY MR. ROBERTSON) Let me rephrase the
8 question. I will withdraw the part "as a legal matter."
9 Same question otherwise.

10 A. Based on what we have presented, which goes
11 far beyond this, I think that the Commission would be,
12 and I submit that the Commission has broad ranging
13 discretion in these matters, I think the Commission
14 would be making a mistake.

15 Q. Thank you.

16 Let me have you take a look, Mr. Pignatelli,
17 still on page 9 at line 17, and you use a phrase, "with
18 oversight of material changes." Do you see that
19 language there?

20 A. Yes, sir.

21 Q. What do you have in mind when you use the
22 word oversight?

23 A. I believe that we have included that in, if
24 you would go to page 6 of A-3, item 12 at the bottom,
25 starting at line 25, "Commission approval of changes to

1 general partner of Saguaro --"

2 ALJ RODDA: I'm sorry, that has two parts.

3 MR. HEYMAN: Could I clarify for the record?
4 He is referring to tab 1 to the witness summaries which
5 is Exhibit A-3.

6 MR. ROBERTSON: I don't have that. May I
7 look over Mr. Heyman's shoulder, Your Honor?

8 ALJ RODDA: If he doesn't mind.

9 THE WITNESS: The difference between tab 1
10 and tab 2 is that tab 1's presentation shows the red
11 line of what we propose to change after discussion, or
12 after the Staff's rebuttal testimony. And it
13 contemplates Commission approval as a, as an operative
14 participation by the Commission.

15 Q. (BY MR. ROBERTSON) So when you make the
16 statement here on page 9, "I am proposing conditions
17 that will provide the Commission with oversight of
18 material changes," is it your testimony that what you're
19 proposing is for the word oversight, you're providing
20 the Commission with the opportunity to approve or reject
21 proposed changes?

22 A. Yes, sir, according to this, yes.

23 Q. Okay. And would you also tell me what is
24 meant by the term or the phrase material changes as it
25 appears here on page 9 of your testimony?

1 A. I'm trying to find the provision because I
2 think it indicates a change of 10 percent.

3 MR. HEYMAN: If I could help speed things up
4 a little bit, with Mr. Robertson's okay, if you will
5 look at page 7, condition 13, titled Commission Approval
6 of Material Changes to Saguaro LP Limited Partners.

7 THE WITNESS: Yes, it's a 10 percent, change
8 of 10 percent.

9 Q. (BY MR. ROBERTSON) Okay. Very good. Thank
10 you, and thank Mr. Heyman.

11 Let's go to page 10 of your rebuttal,
12 Mr. Pignatelli, and although I was present in the
13 hearing room this morning when Mr. Magruder asked you a
14 few questions, I'll be honest, I'm not sure I followed
15 exactly how the two new boards of directors you're
16 proposing for each of the companies, those that would
17 consist of five members each, would be selected, how
18 prospective candidates for the board membership would be
19 identified, and who would actually make the decision to
20 select those people. Would you educate me on that a
21 little bit.

22 A. Yes. Naturally, the shareholders have a
23 vote of who is on the board of directors.

24 Q. Now, assuming that the transaction which is
25 the subject of this proceeding has been approved, would

1 you identify for the record who the shareholders would
2 be?

3 A. The shareholders would be members of
4 management, including myself, would be funds represented
5 by Kohlberg Kravis Roberts, funds represented by
6 J.P. Morgan Chase, funds represented by Wachovia Capital
7 Partners, and Mr. Fred Rentschler would be shareholders.
8 Because we don't have a nominating committee at this
9 point in time, I will make nominations of two
10 independent board members, and two Arizona, not mutually
11 exclusive, and they generally, it's my intention to
12 recommend for shareholder approval carryover of at least
13 three of the existing UniSource board members. And
14 another one that I would recommend would be
15 Mr. Rentschler. I haven't determined, decided on a
16 fourth one at this point in time.

17 Q. Fourth one or fifth one? Sounded like --

18 A. Or a fifth one. I'm sorry.

19 Q. Now, that would cover the first time around
20 there was a selection on the board of directors if I
21 understand correctly that you would in effect be the
22 nominating committee, is that correct?

23 A. Yes, sir, I think I would have to do that.
24 Even though I'm technically not independent, it's
25 probably a little bit of a violation of Sarbanes, but I

1 think we have to establish it to go forward I think
2 would be permissible.

3 Q. Subsequent to the initial nomination and the
4 selection of whoever the ultimate directors are, how
5 would you visualize the process would work in the future
6 in terms of the nomination of directors either for new
7 terms or replacement of directors under whatever
8 circumstances?

9 A. Sarbanes would require that we have an
10 independent nominating governance committee which would
11 make those recommendations to the board which the board
12 would then recommend that slate to the shareholders
13 which is the normal way we do it, and Sarbanes would
14 require that we have total independence on the
15 nominating committee and total independence on the audit
16 committee.

17 Q. And would the shareholder voting strength,
18 so to speak, be roughly the relationship shown on a
19 chart among the various investor entities as tempered to
20 account for the shares held by members of management?

21 A. Yes.

22 Q. Okay. Given the emphasis on ongoing
23 retention of local management, which comes through in
24 your proposal very clear, did you give any consideration
25 to three members of each board of directors being from

1 Arizona?

2 A. I gave more attention to three members of
3 the board being carryover from the existing board,
4 independent of their state affiliation. So I, no, I did
5 not focus on three members being Arizona citizens.

6 Q. Stepping back from the fact that you have an
7 existing board of directors, and you would like to carry
8 over part of that, and that's certainly understandable,
9 conceptually, do you have any objections to three
10 members of the board of directors being from Arizona?

11 A. No.

12 Q. And with regard to the board of directors
13 for each of the companies, conceptually, would you have
14 any objection to each of the Arizona directors, whatever
15 that number might be, being from the service area or
16 service areas served by that particular company on whose
17 board those individuals would serve?

18 A. With a very limited board size, I will
19 strive for, and I would recommend as the first nominated
20 individual to put or recommend people from the
21 communities which we serve. To make it a requirement, I
22 just, I don't know that it is an appropriate
23 requirement. You need to look for different strengths
24 and weaknesses, and you need to have independence under
25 the criteria that Sarbanes has, and I think carryover of

1 three members and independent board members and Arizona,
2 a majority in Arizona, then to say a majority in Arizona
3 in service territory, it just keeps piling on top of
4 piling. I don't know that it's necessary. I don't know
5 that I won't achieve that. I just think, I like some
6 flexibility.

7 Q. Okay.

8 Let me have you turn to page 11 of your
9 rebuttal testimony, and you're speaking here at the top
10 of the page about the Public Utilities Holding Company
11 Act, and I'm looking at your testimony starting at
12 line 1, and you indicate that the Public Utilities
13 Holding Company Act would preclude the investors from
14 controlling the operations of TEP and UES. Do you see
15 that?

16 A. Yes, sir.

17 Q. In what sense would the investors be so
18 precluded?

19 A. Because they own, specifically KKR owns
20 through its funds an electric utility transmission
21 company, they're precluded from owning in a control
22 sense another utility without satisfying the
23 requirements of a public utility holding company.

24 Q. In this sense, are you using the word
25 control interchangeably with the word own?

1 A. No.

2 Q. You seemed to suggest that in your last
3 response. That's why I asked you.

4 A. No, I think the provision looks to, not just
5 ownership but control.

6 Q. Is there a distinction between establishing
7 policy direction and controlling the operations?

8 A. You know, I don't make a distinction between
9 those elements. You mean in the day to day, in my
10 operating head? I make recommendations for the
11 strategic direction, and I, in a very, my requirement is
12 for the day-to-day operations as well. The board as it
13 functions today and as I see it functioning tomorrow or
14 after this transaction would have as its chief
15 responsibility strategic thought, strategic counseling,
16 et cetera. But that's no different than today's board
17 functions, and it's up to me to direct the strategic
18 discussion in accord with where I believe operations
19 have to go.

20 Q. Now, here I'm looking at your testimony as
21 it relates to what the Public Utility Holding Company
22 Act would do vis-a-vis the investors, and so against
23 that background, having the investors in mind, do you
24 see a distinction between establishing policy direction
25 versus controlling the operations?

1 A. I don't think the public utility holding
2 company talks strategic direction versus controlling the
3 day-to-day operations.

4 Q. As you visualize the reorganization, what
5 would be the role, the opportunity for influence or
6 comment or input of the investors to the board of
7 directors with regard to establishing strategic policy
8 of objectives and policy for attaining those objectives?

9 A. I think any owner currently or in the future
10 will want to understand strategic direction, and perhaps
11 if they disagree, at least be convinced that that's an
12 appropriate way to go. I can't distinguish myself
13 because I will be doing day-to-day operations. With me,
14 it's a little different.

15 The board is there to maximize the
16 investment opportunity of its investors, of the owners.
17 That's the obligation of the board. It is now, and it
18 will be in the future. Boards are not there to run the
19 operation day to day. They are only there to look as
20 I've indicated at strategic, at succession. But just
21 like my board today had an obligation to the
22 shareholders to negotiate a good transaction in the
23 interest of the shareholders, so will the board
24 tomorrow, whether this company is owned by 10
25 shareholders or by 10,000 shareholders. The obligation

1 is still the same.

2 Q. Under the new organization if the
3 transaction is approved, will there be an equivalent to
4 the shareholder meeting that the company currently has
5 annually?

6 A. Yes.

7 Q. Will it be in the same sort of setting, so
8 to speak?

9 A. I would assume so, yes.

10 Q. Okay. What other opportunities will there
11 be for investor input to the members of the two boards
12 of directors throughout the year?

13 A. Well, because of the smaller size of the
14 owners, the number, I would probably encourage their
15 participation in strategic discussions. Certainly
16 because of their expertise and their extensive, and this
17 is in a positive sense, influence in the financial
18 markets and the opportunities to reduce costs in the
19 financial markets, I certainly will seek their counsel
20 and their assistance in financial matters. I would
21 anticipate frankly that I will get together with not
22 only the board of directors, but also with the investors
23 on a minimum of a quarterly basis, not much differently
24 than I do now with my existing investors, like make a
25 quarterly call, et cetera, et cetera. But I would

1 anticipate we would sit down and discuss how we're
2 doing, what changes I think should be made. That's the
3 type of discussion I see.

4 Q. A moment ago, you alluded to one of the
5 responsibilities of members of the board of directors
6 being to maximize investment opportunity for
7 shareholders. Let me ask you against that background,
8 earlier today, in response to a question from
9 Mr. Magruder, you talked about how you felt the market
10 at the present time, the financial market, has
11 undervalued the value of the company's stock, and that
12 the investors realize that. Do you recall that part of
13 your testimony?

14 A. Yes, sir.

15 Q. And you pointed out that with the ability to
16 pay down debt, with continued customer growth in the
17 service areas, and assuming no unexpected adverse
18 financial developments that you felt that value would
19 continue to grow looking forward. Do I recall your
20 testimony correctly there?

21 A. Yes, sir.

22 Q. Okay. Aside from customer growth in the
23 company's service areas, and the ability to pay down
24 debt to the extent that's a result of the customer
25 growth, what other factors are you aware of that would

1 have a direct bearing on the value of the investors'
2 investment and the return they're realizing on the
3 investment during the next eight years, to select an
4 arbitrary time frame?

5 A. Probably the most crucial aspect would be a
6 continued constructively positive relationship with the
7 Commission, because our prices that we charge or that
8 we're able to collect are basically a function of the
9 Commission, and they're basically a function of the
10 degree to which the Commission is comfortable that we
11 are managing our operations as efficiently as possible
12 and are providing safe and reliable service. If that
13 trust is broken, this investment will be a bad
14 investment.

15 Q. If that trust is broken, bad things could
16 happen?

17 A. Pardon me?

18 Q. Bad things could happen?

19 A. Yes, yes.

20 Q. Am I correct in understanding that the
21 existing rates and charges for both Tucson Electric
22 Power and for the UniSource utility operations are
23 frozen, so to speak, or cannot be changed for a certain
24 period of time looking into the future?

25 A. Yes, sir, 2007 with regard to UES Electric

1 and Gas, and 2008 with regard to TEP.

2 Q. Will the -- I have not seen the actual
3 document or any of the details on a rate filing that has
4 been alluded to that was made on June 1st of this year.
5 Will that in any way change that rate freeze situation
6 for the two periods of time you have just identified?

7 A. No, sir. The only way it could change would
8 be to reduce pricing.

9 Q. Okay. So the rates and charges that are a
10 part of the investors' opportunity to realize
11 appreciation in value of their investment are those that
12 are currently in effect, at least until the 2007 and
13 2008 dates you identified, is that correct?

14 A. That's correct, with the exception that if
15 this transaction is approved prior to any 2004 review,
16 in the event that the Commission, and I don't think it's
17 possible, could somehow justify a rate decrease, that's
18 at the risk of these investors.

19 Q. Okay.

20 If you will give me just a moment, I will
21 move through your testimony and see what else I've got.
22 Let me have you turn to page 16 of your rebuttal if you
23 would, Mr. Pignatelli, and I'm looking at --

24 A. Yes, sir.

25 Q. -- lines 7 through 10.

1 A. Yes, sir.

2 Q. You're referring to an aggregate amount of
3 approximately 1.5 billion in operating and maintenance
4 expenses and capital expenditures for the years 2005
5 through 2008.

6 A. That's correct, sir.

7 Q. Who will determine what the capital
8 expenditures will be during that period for each of the
9 companies?

10 A. We determine that at the individual
11 operating companies. We prepare a capital budget and an
12 operating budget. The capital budget is approved by the
13 board of directors. The operating budget is not
14 approved by the board of directors. Any capital
15 expenditure that deviates by \$5 million from budget has
16 to go back to the board of directors. That's our
17 current process, and I anticipate that will be the
18 future process.

19 Q. What role, if any, would the investors have
20 in that process?

21 A. They wouldn't. None.

22 Q. None?

23 A. None.

24 Q. Let's move to page 17, and looking at the
25 discussion on lines 19 through 21 that relates to

1 non-utility investments, who will determine what
2 business strategies Millennium pursues, and what types
3 of investments in energy technologies it makes under the
4 new organization?

5 A. The board.

6 Q. The board of which organization?

7 A. The board of UniSource --

8 Q. Of UniSource. Okay.

9 A. -- which is that five-person board
10 essentially that I discussed before.

11 Q. And the process that would be used in
12 developing those business strategies and the types of
13 investments to be made in technology and products would
14 be the process you described just a moment ago?

15 A. Yes, unless those investments are more
16 appropriate in the electric utility, then they would be
17 made at the electric utility.

18 Q. Okay.

19 Let me take you to page 25 of your rebuttal
20 testimony if I might, and you make a statement beginning
21 at line 3 and continuing through line 7, which reads as
22 follows: "If the Commission were to reject the proposed
23 merger, it would send a signal to other potential
24 investors that there is no reasonable set of conditions
25 that are acceptable for new investment in our state.

1 That would obviously have a chilling and negative effect
2 on other potential investors and would in turn
3 significantly increase the cost of capital for all
4 utilities in the state."

5 Now, when I read that last night, my
6 reaction was that it struck me as a bit of a sweeping
7 statement. Let me ask you a very specific question if I
8 might. Aren't there other forms of new investments, to
9 use that specific phrase, that might not engender the
10 same concerns that this particular proposal has
11 occasioned on the part of certain parties?

12 A. We can issue equity in the marketplace, but
13 that is an existing source. I'm trying to think of new
14 sources. This is a market private equity which has not
15 been tapped by either UniSource or Pinnacle, to my
16 knowledge, and I'm not here to testify on Pinnacle's
17 behalf or whatever. This is a huge market of capital,
18 of patient capital with positive, extremely positive
19 implications to the entity. Are there other sources of
20 capital? I could go out and get foreign capital.
21 That's expensive. I could issue equity that's in
22 existence. I could go to the debt markets. That
23 wouldn't change the concerns of the parties if I went
24 out and got more debt. I don't know if that's
25 responsive.

1 Q. I'm not sure if it is either, so let me try
2 a little bit of a tweak on the question. What caught my
3 attention was, as I said, what struck me as the sweeping
4 nature of the statement because it seemed to rule out
5 any form of new investment or alternative approaches
6 that haven't been used before that might receive
7 approval before this Commission and in this state.

8 A. I think that if you start with the
9 proposition that this Commission has in its current
10 rules and regulations adequate protections for the
11 ratepayer, and if you place on top of that 40 additional
12 conditions and put hard requirements on continued
13 dollars of O & M, and if you put hard conditions on
14 maintenance of local operations, and if that fails the
15 test, then it's going to have a chilling impact on any
16 current investor and any future investor. Why would you
17 want to invest in a state that starts from the position
18 that they have adequate control, and you offer
19 additional, and they say no?

20 Q. You obviously believe the statement. That's
21 what's important, and I wanted to ask you about it.

22 Let's go to your direct testimony. I think
23 I may have covered quite a few that I had marked to ask
24 you, but let me take a look here as we go.

25 Let me have you turn to page 6. Starting at

1 line 4 and continuing through line 8, if I understand
2 your testimony correctly, you're saying that you are
3 making a commitment to in the event TEP's bonds are
4 downgraded in connection with the merger that TEP would
5 not seek to recover the cost of interest on those bonds
6 which was greater than the cost of interest on the bonds
7 rated the same as TEP's prior to the downgrade, is that
8 correct?

9 A. That's correct, sir.

10 Q. Is that a commitment you would be willing to
11 see as one of the conditions to any Commission Order
12 approving the proposed merger?

13 A. Yes, sir.

14 Q. Okay. In the event of such a downgrading,
15 what effect on TEP's rating for commercial paper and
16 other forms of financial instruments might occur?

17 A. You know, to me, a downgrading is so
18 illogical, I have a hard time with it because when you
19 take a company and you retire \$270 million of its debt,
20 and you increase its equity to 40 percent, I can't
21 understand intellectually how it's more risky. So I
22 have a hard time with Standard & Poor's right now. What
23 effect a downgrading would have, it would cause an
24 increase in costs. I can't, I don't know, it would
25 depend upon the breadth of the -- you asked about the

1 commercial paper. It would depend on the breadth of the
2 commercial paper market at that time if we were in the
3 commercial paper market. It, it all depends on market
4 circumstances at a particular point in time.

5 Q. Let me tell you what occasioned the
6 question. I looked at your statement, I looked at your
7 commitment, and I know from past experience watching
8 utilities, when a downgrading occurs with regard to one
9 of their securities, quite often it's not limited to
10 that type of security or financial paper. So I wanted
11 to elicit your thinking on what might be the appropriate
12 response if that should occur.

13 A. As I've indicated, that would be a cost.
14 Any change would be a cost that we would have to bear.
15 I'm not expecting the customer or our prices to reflect
16 the cost that would incur from a lower rating than what
17 TEP currently has, as illogical as it may seem.

18 Q. I understand we are talking hopefully and
19 hypotheticals throughout, but I wanted to get to that
20 also. That would not be costs that you would expect the
21 customers to bear, is that right?

22 A. That's correct.

23 Q. Okay.

24 I have a line of inquiry I'm interested in,
25 Mr. Pignatelli, that basically boils down to what's in

1 this transaction for the investors, but it occurs to me
2 it would be appropriate to pose that question to them as
3 a panel. Am I correct in that assumption?

4 A. I can always try, but it would be better to
5 hear from the horse's mouth.

6 Q. I was going to say, are you sure you want
7 to?

8 MR. HEYMAN: I would appreciate it if you
9 wouldn't.

10 Q. (BY MR. ROBERTSON) Let's go to page 18 of
11 your direct. You make a statement starting on line 10
12 which reads as follows: "From their standpoint, the
13 investors I believe became even more convinced that this
14 was a sound long-term investment based upon among other
15 things our service territories, solid management, and
16 low cost generating resources."

17 As that phrase long-term investment is used
18 in the context of your statement there, what time
19 horizon do you have in mind or if you know what their
20 time horizon is, what is that?

21 A. The time horizon I look at is eight to ten
22 years.

23 MR. ROBERTSON: Eight to ten years, okay.

24 Mr. Pignatelli, I think I'm done. Once
25 again, it has been a pleasure.

1 THE WITNESS: Thank you, sir.

2 ALJ RODDA: Thank you, Mr. Robertson.

3 We are going to break for lunch now. I'm
4 going to give you an hour today, so 1:15 back here, and
5 then we'll start with Staff.

6 (A recess ensued.)

7 (Dawna J. Boswell, Certified Court Reporter,
8 was excused from the proceedings.)

9 (TIME: 12:15 p.m.)

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1 (The proceedings were resumed at 1:25 p.m.
2 with Annette Satterlee, Certified Court Reporter,
3 acting as official court reporter.)
4

5 ALJ RODDA: Okay. We are live on the
6 radio. Mr. Pignatelli is still on the stand and I
7 believe, Mr. Kempley, it's Staff's opportunity for
8 cross-examination.

9 MR. KEMPLEY: Thank you, Your Honor.
10

11 CROSS-EXAMINATION
12

13 Q. (BY MR. KEMPLEY) Good afternoon,
14 Mr. Pignatelli.

15 A. Good afternoon.

16 Q. I'll let the roar die down here.

17 I have a few areas that I would like to
18 talk to you about. The first one is some things about
19 the old and new corporate structure and kind of the,
20 this change of institutional investors that you've
21 talked about. When you first talked about that, you
22 talked about it at 70 percent held by institutional
23 investors, and then you've refined that now to let me
24 know that there were ten institutional investors who
25 hold about 50 percent of UniSource's stock? Is that

1 true?

2 A. That's correct.

3 Q. For what period of time has that been the
4 pattern?

5 A. That concentration been a pattern?

6 Q. Not precisely, of course, but generally.

7 A. I think that's been pretty stable over the
8 last, as long as I can recall. We've generally had
9 ten shareholders, institutionals -- and the
10 institutionals will vary -- that have generally held
11 about half of our stock.

12 Q. And then the next thing that's interesting
13 to me about that is that you also indicated that your
14 shareholders turn over about every two years. Is that
15 based on just kind of a rough analysis of the number
16 of shares that trade annually?

17 A. It's if we just take our daily volume and
18 divide it into our total outstanding shares, I just
19 said on average, they would turn every two years.

20 Q. Have any of the three organizations that
21 constitute the group we've called the investors in
22 this proceeding ever been in that mix at all?

23 A. Not to my knowledge. Certainly not in the
24 top ten percent -- top ten holders. And I don't
25 believe they have owned any.

1 Q. I want to talk a little bit about the,
2 what the corporate structure will look like
3 post-merger. And you've talked with some of the other
4 people about that, but in the handout that was passed
5 out the first day of the hearing, the last page shows
6 a chart.

7 Have you got access to that?

8 MR. HEYMAN: Yes.

9 THE WITNESS: Can I ask for a copy to be
10 brought to me?

11 MR. HEYMAN: Your Honor, I do have a
12 packet for Mr. Pignatelli. I also have a blowup of
13 that if that will be helpful to put somewhere.

14 COM. MUNDELL: That would be helpful.
15 Maybe where the no-harm rule is.

16 MR. HEYMAN: No, I like that up there.

17 COM. MUNDELL: It's been up there for a
18 day and a half now. We got it. It's sunk in. May be
19 slow, but it did sink in.

20 ALJ RODDA: Would it help to close the
21 blinds?

22 COM. GLEASON: Yes. Would you please
23 close the blind behind it? The window shade.

24 ALJ RODDA: The glare is --

25 COM. GLEASON: The other one also, too.

1 ALJ RODDA: Thank you.

2 (Commissioner Hatch-Miller enters the
3 proceedings.)

4 COM. HATCH-MILLER: I'm glad I'm sitting
5 on this side. I can read it.

6 MR. KEMPLEY: Thank you.

7 Q. (BY MR. KEMPLEY) Now, Mr. Pignatelli, as
8 far as you know, that chart accurately portrays what
9 the corporate structure would look like if this merger
10 is approved. Isn't that right?

11 A. As far as I know, yes.

12 Q. I'm going to get in a minute to an area in
13 which I think it is not necessarily inaccurate, but
14 incomplete.

15 The way I read this chart, post-merger,
16 UniSource Energy Corporation would be a wholly-owned
17 subsidiary of Saguaro Utility Group I Corp. Is that
18 what that chart appears to portray?

19 A. I think it does, yes. After the merger of
20 UniSource Energy into the acquisition company.

21 Q. Yes. We have talked about the acquisition
22 company acquiring UniSource Energy Corporation and
23 then the acquisition company goes away so that
24 UniSource Energy Corporation is the surviving entity.

25 A. Yes.

1 Q. Now, as far as you know -- well, let me go
2 ahead and do something else before I get to that.

3 You've talked about equity participation
4 on the part of management as being something that's
5 recently been injected into the transaction.

6 A. I take exception with recently. From the
7 time of the transaction approval, it was understood
8 that equity participation would be made available to
9 employees.

10 Q. Okay. Looking at this chart, let me just
11 ask you, which entity among the entities that are on
12 the chart would you expect that employees would have
13 an equity stake in?

14 A. Saguaro Utility Group I.

15 Q. Okay. So, the primary shareholder --

16 A. Let me finish reading something here.

17 Q. Sure. Take your time.

18 A. The investment is going to be made part of
19 the "pray pro su" with all the investors, and I'm just
20 trying to determine which in this corporate structure
21 it is.

22 I'll stay with that answer. When all the
23 dust clears, whichever entity it is, management will
24 have "pray pro su" equity rights along with the other
25 investors. So that's why I'm just trying to be clear

1 on that.

2 Q. So is it perhaps the case that the nature
3 of the ownership interest will not -- hasn't been
4 determined yet?

5 A. The nature? No, it's an entity.

6 Q. Yes, what entity -- I mean, this chart
7 appears to be pretty concrete about how the
8 transaction is --

9 A. The confusion that I have is Saguaro
10 Utility Group, an Arizona limited partnership, and
11 Saguaro Utility Group, a corporation. I believe it's
12 the Saguaro Utility Group Corporation is where our
13 ownership will be.

14 Q. Okay. That kind of follows the next
15 question I was going to have about this. And as we
16 talk this through, maybe -- I don't know if it
17 matters, but we can figure out how this will look.

18 The way the chart appears right now,
19 Saguaro Utility Group Limited Partnership would appear
20 to be the sole shareholder of Saguaro Utility Group I.

21 A. See, and that's where I think the chart,
22 in its attempt at simplification, is perhaps
23 misleading.

24 Saguaro Utility Group Partnership will
25 make an investment in Saguaro Utility Group, the

1 corporation. It won't own a hundred percent of the
2 latter, it will own a hundred percent minus whatever
3 the ownership is of management.

4 Q. And is it determined at this time what
5 percentage ownership in the corporation will be
6 available to management?

7 A. I believe there will be somewhere between
8 five and seven percent available for management, but
9 it's a function of what management invests how much
10 the ultimate amount will be. Because we will be
11 putting our cash in to purchase equity. And I don't
12 know how much the individual officers are prepared to
13 invest. I know that I'm prepared to invest \$5
14 million.

15 Q. I understand. I understand that nature of
16 the transaction.

17 Is it safe to say that it is highly
18 unlikely that it would exceed ten percent?

19 A. I think that's very safe to say. I do not
20 believe that management will have ten or more percent.

21 Q. And just to kind of close the loop here,
22 if I understand the chart and kind of my general
23 awareness of the transaction, Saguaro Utility Group,
24 the limited partnership, exists today, doesn't it?

25 A. That's correct.

1 Q. And it consists of KKR Funds, JPMP Funds,
2 WCP Funds as limited partners and Sage Mountain,
3 L.L.C. as the general partner.

4 A. That's my understanding.

5 Q. Now, if the structure that we're talking
6 about, including management ownership, is the correct
7 one, it would still be true that Saguaro Utility
8 Group I, the corporation, would be the sole
9 shareholder of UniSource Energy Corporation after the
10 merger.

11 A. Yes. That is true.

12 Q. Now, what I want to talk a little bit
13 about is the consequences of that ownership. And for
14 purposes of the discussion, I want to set aside the
15 conditions that we anticipate being approved in the
16 Commission's order in this matter and talk about what
17 kind of control would exist in the absence of any
18 conditions. I --

19 A. Okay. I understand. I think I
20 understand.

21 Q. If there were no conditions, wouldn't it
22 be true that Saguaro Utility Group I, as the sole
23 shareholder of UniSource, would have pretty much
24 absolute authority to elect the board of directors of
25 UniSource Corporation?

1 A. The board of directors are elected by the
2 shareholders. If you have one shareholder that has or
3 controls all the votes -- understanding that that
4 company has a myriad of shareholders. But in your
5 hypothetical, that entity would have the total vote of
6 the directors for the underlying. It's no different
7 than what we have now with UniSource and with TEP.
8 UniSource is the sole owner of TEP. UniSource
9 shareholders elect the board at UniSource, and
10 UniSource elects the board for TEP, UES, UniSource
11 Electric and Gas, Gas and Electric. And the boards at
12 UniSource Electric and Gas currently are different
13 than the board at TEP and the board at UniSource is
14 slightly different than those downstream boards.

15 But it's much the same as we currently
16 have. UniSource to TEP would be the same as Saguaro
17 Utility Group I to UniSource and then UniSource to TEP
18 and to UES Electric and Gas.

19 Q. Well, that may all be true, but on this
20 chart, if you trace back from Saguaro Utility Group I,
21 you don't ever get to really a myriad of shareholders
22 for Saguaro Utility Group I, do you? Don't you only
23 get -- I'll try to short circuit this, but I think you
24 really get the KKR Funds, who owns the 62 percent
25 economic interest in the limited partnership. And,

1 frankly, it seems like it would exert pretty
2 significant control over the whole organization.

3 A. That's something you should address with
4 the panel because I don't know the voting rights in
5 that partnership. I can't speak to that.

6 Q. Well, then, let's look at it from a
7 slightly different perspective.

8 The limited partnership as I understand it
9 essentially speaks through its general partner. Isn't
10 that right?

11 A. I think that would be correct. But in --
12 for fear of putting different testimony from two
13 different witnesses on the same subject on the
14 transcript, I would prefer that you reference those
15 questions to the panel because that's their structural
16 part.

17 Q. Okay. And you aren't concerned about the
18 possibility that this corporate structure could result
19 in a small group exerting significant control over the
20 election of the board of directors of UniSource Energy
21 Corporation?

22 A. No. I am not concerned.

23 Q. But you don't have an opinion, at least
24 you'd prefer not to express an opinion over whether
25 that would be the theoretical possibility that this

1 corporate structure implies.

2 A. I would rather not pro-offer testimony in
3 an area which I don't know.

4 Q. Now, you described the function of the
5 board of directors -- and you've done this several
6 times in the course of your testimony -- as being to
7 control strategy, financing, and succession.

8 A. No. It's not to control. I never used
9 the word control.

10 Q. Direct.

11 A. The function of a properly functioning
12 board is to provide advice and counsel as to strategic
13 direction, input as to strategic direction; to provide
14 and counsel and input as to financing plans and
15 alternatives and to assure that there is management
16 succession.

17 Q. What elements of the business, if any,
18 does the board of directors actually control?

19 A. The only elements that a board controls is
20 what is provided by the particular bylaws of an
21 organization. TEP's bylaws, because of the issues
22 they had in the late '80s, restrict management's
23 discretion with regard to capital expenditures. And
24 the capital budget under our current requirements must
25 be approved by the board, and any deviation from

1 capital budget in the extent of \$5 million must be
2 approved by the board. Those are restrictions on
3 management that were put in place by the board in a
4 prior period. Whether those will be -- I think that
5 those are a little too constraining and I will be,
6 most likely, removing some of those to make that more
7 workable.

8 Q. Does the board of directors have -- again,
9 absent conditions or restrictions, does the board of
10 directors normally have hiring and firing authority
11 over the CEO?

12 A. Yes.

13 Q. And, now, you talked in answer, two
14 answers ago about what a properly functioning board
15 does. And earlier, I think yesterday, I heard you say
16 that the areas of financings, strategy and succession
17 are areas in which a good board interacts with
18 management.

19 What kind of things can a bad board cause?

20 A. Anxiety in the CEO. I've been on a lot of
21 boards. I've seen attempted mischief on behalf of
22 some major shareholders. And independent board
23 members function, in my history, function very capably
24 to protect the company and to preserve the company in
25 its mission.

1 And I am confident that this board will be
2 effective and constructive in not only embracing what
3 our mission -- safe, reliable service -- is, but
4 encouraging and enabling it. Because that's the only
5 way that this board can fulfill its obligation to the
6 shareholders, because the shareholders will stand to
7 lose the value of their investment if TEP and UES
8 Electric and Gas don't continue to run in the best
9 interest of the consumers, reflecting safe, reliable
10 service and the needs and desires of the regulator who
11 establishes prices and terms and conditions of
12 service.

13 Q. And I wasn't trying to imply anything
14 particular with respect to either the existing board
15 or an incoming board of directors. What I was trying
16 to explore, really, was what the potential negatives
17 are if a board of directors is put in place that
18 doesn't necessarily either share management's vision
19 or have a vision that is constructive for the
20 organization. Bad things can happen, can't they?

21 A. I don't mean to be obstreperous, but in
22 all the boards that I have seen, they don't become
23 dysfunctional because the base interest of that board
24 is the preservation and enhancement of the value of
25 the shareholders' equity. And that base objective,

1 especially in our industry, is very much consistent
2 with the needs and the requirements of the community,
3 the customer and the Commission.

4 So I just have a hard time -- I'm not
5 trying to be obstreperous and I'm not reading anything
6 negative into your question. I just have a hard time
7 accepting the premise because I understand the
8 responsibility of those boards.

9 Q. Well, and I'm not trying to be
10 argumentative, but let me just ask it this way:

11 The investors that are at the top of the
12 pyramid here aren't entities that have experience in
13 the operation of a utility business. You've said
14 that. And, yet, the way I see the corporate
15 structure, they have significant ability to influence
16 the membership of the board of directors. And if they
17 took a different view of the way your business should
18 be run than you do, I'm not saying this would happen,
19 but it seems that in the absence of appropriate
20 conditions, there would be opportunities for mischief.
21 Do you agree with that?

22 A. There's always opportunities for mischief.
23 Today, ten large shareholders could change the
24 structure of the board. This is maybe putting three
25 large. But to do that, Mr. Kempley, it's an anathema

1 to my logic because to do that, the investors would
2 have to be mad at their money because they are
3 diluting the entire value of their investment. If
4 they take actions which are contrary or advise the
5 board to take actions or change the board out such
6 that it would take actions which are contrary to its
7 operating management's recommendations which are
8 consistent, the management's recommendations, with the
9 provision of safe, reliable service -- because the
10 whole investment premise depends on creating value by
11 creating a strong utility, which is continuously price
12 and conditions of service and many other things
13 regulated by the ACC. There is no change in that.

14 And to create an environment through
15 shareholder action which would create a board which
16 would not satisfy the needs of the consumer and the
17 needs of this Commission would be getting mad at your
18 money and wasting it as the investor. I firmly
19 believe that. I can't say it too many times.

20 Q. I would like to move on and talk a little
21 bit about the one and a half billion dollar commitment
22 on O&M and capital investments.

23 A. Yes, sir.

24 Q. I guess I was a little surprised, although
25 I probably shouldn't have been, when you told us today

1 that the capital required for the Nogales transmission
2 line would be separate from that one and a half
3 billion dollars that's discussed in your testimony.

4 Can you give me more discussion about
5 what's in that figure and what kinds of things are out
6 of it?

7 A. That would include, those figures include
8 my best estimate of operation and maintenance expenses
9 for the next four years. It would include all the
10 capital additions at our existing generation
11 facilities. It would include all of the capital for
12 new equipment, substations, new hookup with our
13 current growth rated projected at about three percent
14 in TEP and about six percent at UES Electric and Gas.
15 I'm trying to remember if out in 2008 it starts to
16 include some preliminary new generation out there. It
17 could pick up a little of the Nogales line as we got
18 out into the, out into the future.

19 Because of the permitting status of that,
20 and the lead time, I think that that line has probably
21 been moved out into 2007, 2008. So it could have
22 small amounts of that; I just don't know. I can't
23 give you an item-by-item because I don't have my
24 capital budget with me.

25 Q. You probably helped me a lot by the answer

1 you just gave me.

2 The reason it's not in this figure isn't
3 because it in some different category; it's because of
4 the timing of the expenditure.

5 A. It's basically because of the timing of
6 the expenditure. I still don't know where that would
7 ultimately be owned, but I believe that we've started
8 to bring it into our farther-out forecast.

9 Q. And what I wanted to just kind of talk
10 about a little bit, it's less important given the
11 distinction is a timing one rather than a category
12 one, but what are the likely sources of capital
13 outside what's included in the one and a half billion
14 dollars if you had a significant capital expenditure
15 like this transmission line during the time horizon
16 here?

17 A. Well, right now, I think we have adequate
18 additional internal generation to even fund that line.
19 But let's make it a different hypothetical if I may.

20 What happens if there is a major
21 generating plant that's needed? Let's say that the
22 Commission decides that we need 300 megawatts of
23 generation to be owned by UniSource Electric. Can we
24 accept that for a minute?

25 Q. Sure. Please. It will help.

1 A. We will have all of the traditional
2 sources of capital available. This --

3 Q. Let me stop you --

4 A. No, no. Let me finish with that
5 statement.

6 Q. Okay. Go ahead.

7 A. These investors have assured us that we
8 can go back to the equity markets if they for some
9 reason have an inadequate amount of capital to put in.
10 We have not changed our access to any market. We have
11 just increased our access to a new market. It gives
12 us more security, more -- it gives me more ability to
13 stand up and look you in the eye and say I'm going to
14 have the money. I have broader financial sources than
15 I do now. I have companies that are, have 40 percent
16 equity that have broader sources of debt financing
17 available.

18 Any debt that any of the companies would
19 take on would have to come from -- with Commission
20 approval. I understand that. And this also goes to
21 why I'm reluctant to increase my commitment to
22 pre-retire debt because I do see a need out there for
23 potentially more generating resources. A lot of it
24 depends on what happens in track B and others, which
25 we're sort of in limbo waiting to see what happens.

1 That's why I'm reluctant to commit to paying further
2 down cheap, tax-exempt debt when I think that I might
3 have to go out and finance new generation as we go
4 out.

5 But we -- the answer to your question --
6 I've sort of droned on -- is that I firmly believe
7 that these investors provide us the same access to
8 existing markets and an additional access to a much
9 broader market that we have no access to now.

10 Q. Well, let me ask you just a couple
11 questions about that.

12 You indicated that the investors have
13 assured you that you would have the ability to go back
14 to the equity markets if need be.

15 A. Yes, sir.

16 Q. Is that assurance embodied in any writing
17 anywhere?

18 A. I think it's -- that specific language, I
19 don't think is in any language. But there is
20 something that says that there will be adequate
21 capital available to provide for the needs of the
22 utilities. And it's -- that's in writing,
23 Mr. Kempley.

24 Q. Okay. And --

25 A. I don't think there is a specific,

1 in-writing saying and by this adequate availability of
2 capital we mean you can go to the equity markets if
3 you so desire.

4 Q. But you think that in some of the
5 documents on the transaction, there is embodied a
6 commitment to supply adequate capital for the conduct
7 of the utility business.

8 A. To enable us to access adequate capital,
9 or that required for the provision of safe and
10 reliable service. I think that's sort of the
11 language.

12 Q. And I assume that it doesn't include any
13 kind of more detailed description about who or how
14 what's adequate would be determined. That's just a
15 general assurance from the investors. Is that --

16 A. That's a general assurance from the
17 investors. Adequate, I think I've taken that as what
18 I define as adequate. What we define as adequate as a
19 combined group, the Commission, the Staff and the
20 company, is what is needed to provide safe, reliable
21 service.

22 And I'm struggling a lot because I don't
23 know where the Commission is going to go with regard
24 to generation, and that is really, that is really the
25 unknown. I can tell you that in the 1.5 billion,

1 there's adequate capital for necessary transmission
2 and distribution. Right now, we're supposed to buy
3 any excess -- any needs in excess of our current
4 generation from the marketplace. If that changes --
5 and that's a wild card that these investors understand
6 and are willing to take, that at some point in time
7 the Commission might say you have to provide all the
8 generation. Well, I hope they tell us pretty soon
9 because we are going to be in a mad scramble. That
10 certainly has to be in the loop.

11 Q. So let me just kind of back up to the
12 starting point of the answer you just gave.

13 You would think based on the assurance
14 that the investors have given that if the Commission
15 directed a particular form of capital requirement,
16 that that would meet the definition of being adequate
17 for purposes of putting the investors on the hoof, if
18 you will, to supply that capital.

19 A. Not a specific form of capital.

20 Q. For a specific purpose.

21 A. If that purpose is consistent with the
22 provision of safe, reliable service to our customers,
23 yes.

24 Q. And just to kind of close one small loop
25 on this, if for some reason you were to need to go

1 back to the equity markets as you've indicated,
2 wouldn't that involve either UniSource Energy
3 Corporation or Saguaro Utility Group Corporation doing
4 some kind of a public offering that would be, in
5 effect, a whole new ballgame? An IPO?

6 A. It could -- yes. It would be an issuance
7 of stock to the marketplace.

8 Q. I would like to talk a little bit about
9 the 60/40 debt-equity ratio. And you've said on many
10 occasions that the 60/40 debt-equity ratio has been
11 targeted by the Commission, and I assume that at least
12 for that reason it has been a target of the company.

13 A. Yes. The target has been increased
14 recently by the Commission. It was 37 and a half
15 percent and we targeted 37 and a half and then that's
16 been increased to 40, and that's the aspiration of the
17 company.

18 Q. And, in fact, in your testimony in the
19 last couple days, you've indicated your belief that
20 attaining that 60/40 debt-equity ratio is a benefit,
21 one benefit from the transaction.

22 A. Yes, sir.

23 Q. Do you believe that a 60/40 debt-equity
24 ratio is an ideal capital structure for an electric
25 utility?

1 A. The ideal capital structure is a function
2 of, in my opinion, what the lowest effective cost of
3 capital, weighted cost of capital is to the consumer
4 ultimately. And I believe that for the immediate
5 future with TEP and UES, a 40 percent equity, 60
6 percent debt is the appropriate structure. Whether
7 that carries over time, it's a function of how the
8 company is reflected on, in the debt markets and what
9 the need for additional sources of capital to the
10 company are. But I would say for TEP and UES that
11 40/60 is the appropriate one for -- at this point in
12 time.

13 Q. And in answering, you talk about a capital
14 structure that provides the lowest weighted cost of
15 capital for the utility. Is TEP debt currently
16 investment grade?

17 A. Barely. We've been improving our ratings
18 recently and we are double B plus at S&P.

19 Just to, because you repeated my answer
20 there, it's the lowest cost of average capital
21 consistent with the needs, capital needs of the
22 utility consistent with meeting its obligation to
23 provide safe and reliable service. I just can't leave
24 it that it's just the lowest cost because there are
25 other things.

1 Q. You indicated that you believe you're
2 currently, your debt is currently rated double B plus
3 by S&P. Do you know when that change occurred?

4 A. Actually, I think I just told you
5 something that hasn't come out yet. I was looking for
6 my chart on my current ratings. May I ask that the
7 chart -- never mind.

8 As of June, we are at double B plus at
9 Fitch, triple B minus at S&P, and a BA2 at Moody's.

10 Q. Do you know -- well, can you tell me what
11 piece of paper you're reading off of? What that
12 document is?

13 A. Yes. This document is a TEP credit rating
14 history from September of '88 through June of '00.
15 It's something that's an internal document that you're
16 more than welcome to have --

17 Q. Yeah, I would like a copy of that at some
18 point. Not necessarily right this minute.

19 MR. HEYMAN: Would you mind if I go up
20 and look at that for one second?

21 ALJ RODDA: Okay.

22 THE WITNESS: I was talking about the
23 first mortgage bonds. You want the rest? I mean, we
24 have multiple ratings.

25 MR. HEYMAN: If I could just consult with

1 him for one second.

2 ALJ RODDA: Okay.

3 THE WITNESS: If I can extend my
4 answer --

5 MR. HEYMAN: Your Honor?

6 THE WITNESS: -- unsecured debt --

7 Q. (BY MR. KEMPLEY) Let's do unsecured debt.

8 MR. HEYMAN: Let me just make a point to
9 the judge before I --

10 ALJ RODDA: I'm sorry. Yes?

11 MR. HEYMAN: There is a document that we
12 can produce that Mr. Pignatelli is looking at. We
13 have a clean copy that we will make some copies and
14 get it during the break if that's okay. Or, if you
15 want us to make copies now so people can look at them
16 while you're asking --

17 MR. KEMPLEY: Now would be fine. Maybe
18 we can take a break and do that.

19 MR. HEYMAN: Okay. We will provide it to
20 you.

21 ALJ RODDA: Okay.

22 (A recess ensued.)

23 ALJ RODDA: During the break, Mr. Heyman
24 has passed out a credit history.

25 MR. HEYMAN: Yes, Your Honor. If I could

1 just identify the document that Mr. Pignatelli was
2 referring to and lay the foundation and have it moved
3 in evidence, if that's okay, Chris.

4 MR. KEMPLEY: That would be fine.

5 MR. HEYMAN: We have had marked for
6 identification as Exhibit A-4 a one-page document that
7 has at the bottom B12 and at the top says UniSource
8 Energy, TEP Credit Rating History.

9 Mr. Pignatelli, was this the document you
10 were referring to in response to questions from
11 Mr. Kempley previously?

12 THE WITNESS: Yes, it is.

13 MR. HEYMAN: With that, I would like to
14 move this into evidence.

15 ALJ RODDA: Any objections to A-4?

16 Hearing none, A-4 is admitted.

17 MR. HEYMAN: Thank you.

18 THE WITNESS: I apologize for the
19 confusion.

20 Q. (BY MR. KEMPLEY) That's all right,
21 Mr. Pignatelli. I asked the question. You just tried
22 to answer it.

23 A. And I gave you the first mortgage bonds
24 and I think you had then asked for the unsecured debt.

25 Q. Yes.

1 A. And Fitch is a double B minus; Moody's a
2 BA3, and Standard and Poors a B plus. And I referred
3 that, I had indicated in my testimony that we have
4 just been notified that our bank facility, the 400
5 million bank facility just received a double B plus
6 from S&P. That's consistent with the prior bank
7 facility and that is second mortgage bonds which are
8 not really shown on here. But they're second mortgage
9 bonds.

10 I apologize for the confusion I created.

11 Q. Let me just ask this kind of final
12 question off of Exhibit A-4.

13 Exhibit A-4 ends in June of 2000. Have
14 there been any rating upgrades that you're aware of
15 since June of 2000?

16 A. None that I am aware of other than that
17 reaffirmation of the double B plus on our second
18 mortgage.

19 Q. And just to be clear, the BB plus would
20 not be an investment grade rating. Isn't that right?

21 A. That's correct. And we continue on credit
22 watch from S&P.

23 MR. KEMPLEY: Thank you.

24 This would be a good break point then,

25 Your Honor, to let Commissioner Gleason ask his

1 questions.

2 ALJ RODDA: Okay.

3 Commissioner Gleason, you had a couple
4 questions?

5 COM. GLEASON: Yes. If I can pursue the
6 line of questioning that Mr. Kempley had from a
7 different angle, are these shares of stock and, from
8 these various entities, are they pledged? Are they
9 pledged as collateral on any of these operations? I
10 especially -- I think the UniSource shares that are
11 owned by Saguaro Utility I, can they be pledged as
12 collateral?

13 THE WITNESS: I do not believe they are.
14 I know that no shares of TEP or UniSource Electric or
15 UniSource Gas are pledged as collateral for any debts
16 of Saguaro LP, and I do not believe that any share, it
17 is contemplated that any shares of UniSource Energy be
18 pledged as collateral.

19 COM. GLEASON: If you go up the line,
20 shares of Utility I, can they be pledged? We're
21 getting up -- as you get up the line, they can be sold
22 freer and freer of restrictions. Isn't that correct?

23 THE WITNESS: Except, Commissioner, the
24 conditions which we discussed earlier which restrict
25 and preserve your right to consent to -- and I'm

1 referring to conditions 12 and 13 which are found on
2 pages six and seven behind tab one of my testimony,
3 A-3, which require that Commission approval be
4 obtained to change ownership or membership of a
5 general partner, and also 13, which provides that
6 Commission approval is required if more than ten
7 percent of the economic interest in the limited
8 partner, Saguaro LP, is sought to be sold.

9 So the Commission has, by these
10 conditions -- and these conditions were negotiated and
11 fought very hard for by your Staff. These conditions
12 actually give the Commission authority and approval
13 over companies that at best fell within the affiliate
14 transaction rules, but this gives you complete
15 authority over the sale, approval over the sale of ten
16 percent of that or anything in the general partner.

17 It was just quite far-reaching as far as
18 your, in my opinion, your control over those entities
19 and the ownership of those entities.

20 COM. GLEASON: Thank you. Let me shift
21 gears.

22 This 1.5 billion that you talk about, the
23 source of those funds are the operations of TEP? UNS
24 Gas?

25 THE WITNESS: Yes, sir. We do generate

1 adequate internal funds to provide for those levels of
2 capital investment and O&M. And, actually, over and
3 above those utilization of that cash, we're still
4 committing to pre-retire additional debt out of
5 internal cash. So, the 1.5 billion is basically
6 provided from internal funds and the additional debt
7 reductions are accomplished through utilization of
8 internal funds.

9 COM. GLEASON: The reason for pursuing
10 that is, to me, TEP performance would be higher
11 priority than, for instance, service and quality of
12 service. Now, if things really go south in the
13 economy and you have trouble providing that, would it
14 be well to have an out on that to come to the
15 Commission and allow you to cut back on that capital
16 improvements?

17 I'm trying to get -- I hate to have this
18 thing nailed down. And I'm not feeling sorry for you
19 or the company, I'm feeling sorry for the guy that's
20 paying the bill out there if you have to cut his
21 service because we've narrowed you on the other end.

22 THE WITNESS: No, if the economy really
23 went south, under what you're saying, and we couldn't
24 fund the 1.5 billion with internal funds, then the
25 investors have committed to put the necessary funds in

1 to assure that that 1.5 is there.

2 The 1.5 billion, that's our obligation.
3 It's currently being funded with internal funds, but
4 if internal funds are inadequate, investors have to
5 provide us the wherewithal to do that, to provide that
6 same amount of O&M capital.

7 COM. GLEASON: That was my --

8 MR. HEYMAN: Your Honor.

9 COM. GLEASON: I wanted assurance that
10 you wouldn't have to cut something else to get that.
11 But you will get that one way or another is what
12 you're --

13 THE WITNESS: Yes, sir. And that's one
14 of the values -- this is another element that the
15 Commission Staff and the company has worked together
16 to try to get language that would give you assurances
17 where now we only have budgets and hopes. Now, that's
18 a hard number that you can hold the company and its
19 new owners to make sure that that money is provided,
20 whether it's available from internal generation or
21 whether it's not available from internal generation.
22 And that's -- these conditions provide so much more
23 authority and so much more power to this Commission
24 that I think they really merit your consideration.

25 COM. GLEASON: Okay. I wanted to --

1 MR. HEYMAN: Commissioner, if I might.

2 COM. GLEASON: Sure.

3 MR. HEYMAN: I know this is a little bit
4 unorthodox, but I know this is an important point and
5 I wanted to make sure the record is clear on this.

6 The issue that you brought up actually is
7 in the condition that we have proposed and the
8 language there. It says that the companies, without
9 prior approval from the Commission, will not spend
10 less than the \$1.5 billion. So as we are proposing
11 that -- there is a provision to come to the
12 Commission, and the Commission ultimately still has
13 control over that issue. I just want to make sure
14 that that was in the record at the same time when
15 people were looking at that.

16 COM. GLEASON: I thank you for that. I
17 remembered that from someplace, but darned if I could
18 find it sitting up here.

19 MR. HEYMAN: It's in condition four.

20 COM. GLEASON: Thank you very much.

21 MR. HEYMAN: Again, I apologize, Your
22 Honor. Thank you for letting me interject that.

23 COM. GLEASON: Thank you.

24 The other thing, I have to leave pretty
25 soon, but quickly, back to somewhat the same with the,

1 you have guaranteed a level of contributions in that
2 agreement.

3 THE WITNESS: Yes, sir.

4 COM. GLEASON: I guess my point is, let
5 me start -- those contributions that you're making now
6 are really stockholder funds, right?

7 THE WITNESS: That's correct. We don't
8 include contributions in our cost of service when we
9 come from rates proceedings.

10 COM. GLEASON: I guess part of this
11 question is back to Mr. Kempley, but if we mandate
12 this, are they going to go back to rate base?

13 MR. KEMPLEY: Commissioner Gleason, as I
14 understand the conditions, there isn't anything about
15 them that would change the treatment for rate-making
16 purposes of any charitable contributions.

17 THE WITNESS: I concur with Mr. Kempley.
18 There is no intention on behalf of the company to come
19 back and seek rate recovery for contributions that we
20 commit to in this proceeding. Even though you would
21 be adopting that commitment, we will not treat it as
22 an imposition of a cost by the Commission.

23 COM. GLEASON: That was my concern.

24 Thank you.

25 ALJ RODDA: Thank you.

1 Mr. Kempley.

2 MR. KEMPLEY: Thank you.

3 Q. (BY MR. KEMPLEY) Back to me,
4 Mr. Pignatelli.

5 I have a couple of cleanup questions that
6 may sound a little bit out of sequence, but since we
7 had a break, let me ask them anyway.

8 I just wanted to make sure from your prior
9 answers to questions, is it your understanding that
10 post-merger, UniSource and TEP will continue to file
11 all the documents that are currently filed with the
12 SEC, including 10(k), 10(q) and proxy statements?

13 A. Yes, sir. It's my understanding.

14 ALJ RODDA: Wonder whose phone that is.

15 MR. KEMPLEY: It's probably webstreaming
16 nicely.

17 Q. (BY MR. KEMPLEY) Now I'll get a little
18 bit back to where I was.

19 Would you agree with me that that is
20 generally desirable for an electric utility to have
21 investment grade credit ratings?

22 A. Yes. It's all of our objective.

23 Q. And when you talked about a capital
24 structure that -- I don't want to mischaracterize your
25 answer, but an optimal capital structure, one of the

1 objectives is typically investment grade credit
2 ratings, isn't it?

3 A. Yes, sir.

4 Q. Do you have any reason to believe that the
5 consummation of this proposed merger will result in
6 investment-grade credit ratings for UniSource or TEP
7 where they might not currently exist?

8 A. I don't think we quite make it. If we
9 utilize some cash to buy in leases that are
10 capitalized and figured into the calculation of debt
11 equity by the rating agencies and start to build our
12 equity a little bit more in that fashion, I think we
13 can perhaps reach it in the not too distant future
14 from Moody's and perhaps Fitch. Standard and Poors, I
15 think is a little longer. I would see rating
16 increases faster at Moody's and Fitch than I would at
17 Standard and Poors. But we still have a ways to go to
18 get to investment grade.

19 Q. Have you seen any pronouncements from any
20 of the rating agencies that lead you to believe there
21 would be immediate increases in the credit ratings
22 upon consummation of the merger?

23 A. No. No, I have not.

24 Q. And just to close up kind of one other
25 loop here, when we are talking about a 60/40

1 debt-equity ratio upon consummation of the merger, how
2 does that account for the leases?

3 A. That accounts for the leases as operating
4 as opposed to capital leases. And that's consistent
5 with what the Commission and the company is required
6 to do under Arizona law.

7 And that's why I say the 60/40 is as the
8 Commission measures it, not necessarily how the rating
9 agencies measure it. It would be more in the 20, mid
10 20s in equity the way the rating agencies measure it.
11 And that's one reason I'd like to focus a little bit
12 maybe on buying in some of those leases so that we can
13 get that also moving up as opposed to buying in
14 tax-exempt debt. I would rather buy in some of those
15 leases to try to get the rating up with the rating
16 agencies. Get the equity ratio up with the rating
17 agencies.

18 Q. I would like to talk briefly with you
19 about the -- my note here just calls it the difference
20 between the 400 and the 500 million dollar pay down.
21 You know what issue I'm talking about?

22 A. Yes, sir.

23 Q. You probably don't have it with you, but I
24 would like to have Mr. Antonuk's surrebuttal testimony
25 available, if counsel could make that available.

1 MR. HEYMAN: Your Honor, if I might.

2 ALJ RODDA: Yes, please.

3 Q. (BY MR. KEMPLEY) If you could turn to
4 page four of Mr. Antonuk's surrebuttal testimony when
5 you get it.

6 A. Yes. I have it.

7 Q. Have you reviewed this testimony before?

8 A. No, I have not.

9 Q. I hate to do this in the middle of the
10 proceeding, but if you could take a few minutes and
11 read maybe the next two pages, pages four and five.

12 A. Starting from line ten?

13 Q. Starting with the question at line ten.
14 Just take your time and let us know when you've had a
15 chance to read through about the end of page five.

16 A. I have it in front of me. I can see it.

17 Q. Okay. Now, I think, and I just want to
18 confirm that having read it, you agree that this is
19 the place in Mr. Antonuk's testimony where this 400
20 versus 500 million dollar pay down of debt is
21 discussed. Is that what it looks like?

22 A. It is a place. If you say it's the only
23 place -- I haven't read the whole testimony.

24 Q. And I don't pretend that it's necessarily
25 the only place. But it is discussed there.

1 A. Yes, sir.

2 Q. And first let me get one clarifying point
3 because you've talked about concerns and your
4 preference to pay down lease debt as opposed to other
5 debt.

6 In Mr. Antonuk's formulation, he doesn't
7 preclude using the extra hundred million dollars to
8 pay down lease debt, does he?

9 A. No. He does not.

10 Q. At page five, he talks about -- the
11 question and answer that start at line 13, he talks
12 about a January 2004 presentation by TEP to potential
13 lenders.

14 A. Yes.

15 Q. Were you a part of that presentation?

16 A. I don't know that I was a part of it, but
17 I am familiar with what was in it.

18 Q. Do you have any reason to believe that the
19 description that Mr. Antonuk gives of that
20 presentation is inaccurate?

21 A. I have no reason to believe that it's
22 inaccurate.

23 Q. And if Mr. Antonuk has fairly represented
24 the presentation, wouldn't it be fair to say that that
25 presentation would have anticipated that the company

1 would be in a position to make the \$500 million of
2 debt and capital lease reductions that Staff proposes?

3 A. No. I think the problem is inherent in
4 the \$138 million by 2008 of the TEP first mortgage
5 bonds. I think that encompasses some of the 30
6 million annual voluntary, and I'm afraid that there
7 might be, in Mr. Antonuk's mind, maybe a double
8 counting of some of that element. He goes to 500, we
9 go to 400. We also have scheduled retirements, like I
10 said, in excess of two hundred.

11 I'm struggling. I want us to come to an
12 agreement on this condition because it's the only one
13 that's outstanding. It's, it's -- I don't want to
14 have to commit to something I don't think I can do. I
15 will not commit to something I'm not assured I can
16 accomplish. I want to come to a conclusion --

17 Q. Well, let's do this. I think maybe, at
18 least between us right now, we can reach an
19 understanding of where you believe the difference is.
20 It appears from the answer you just gave that you
21 believe in Mr. Antonuk's proposal of \$500 million he
22 accounts for the \$138 million and adds the \$30 million
23 of annual voluntary lease buy backs to that amount?
24 And you don't seem to think those are additive?

25 A. I am concerned with it. I think

1 Mr. Antonuk gets to 500, and he certainly -- you can
2 correct me if I'm incorrect, by taking 263 and adding
3 138 and adding 120. And I think that that's double
4 counting some of that 30.

5 Q. Okay. Let me just have you -- and we
6 probably won't be able to resolve this while you're on
7 the stand. I just want to make sure that we pinpoint
8 it.

9 Mr. Antonuk's description at line 20 is
10 that the \$30 million annual is voluntary lease debt
11 buy backs, and that would seem to be different than
12 the \$138 million of first mortgage bonds that he
13 described immediately above that. So, by itself, it
14 doesn't look like it's double counting.

15 A. No, because my understanding was the 30
16 million was to pre-retire debt, not necessarily lease
17 debt.

18 Q. Okay.

19 A. And that's -- to my best knowledge, I'm
20 only comfortable with guaranteeing to this Commission
21 that I'll do 400. If I can do 500, I'll do 500, but I
22 only want to be held accountable for 400.

23 Q. Let me ask you this question, then.

24 I think the process contemplates that
25 you're going to take the stand again at the very

1 conclusion of the proceedings. Would you be willing
2 to take a look at that issue -- and maybe we can have
3 discussions outside the hearing -- and respond again
4 in your final rebuttal as to whether, upon further
5 examination, you still believe that there's a double
6 counting?

7 A. Certainly. I would hope that we can
8 resolve this very minor issue between us.

9 Q. My last area of questions involves some
10 questions that involve ring-fencing. And I'm going to
11 be working off your rebuttal testimony at page 13.

12 A. You're referring to A-2?

13 Q. It's probably been updated by A-2. I was
14 looking at the rebuttal testimony when I did the --

15 ALJ RODDA: A-2 is the rebuttal.

16 MR. HEYMAN: Chris, A-3 is the one that
17 has the red-lined. A-2 is the rebuttal.

18 MR. KEMPLEY: Condition two in whatever
19 the final form is is going to be the --

20 MR. HEYMAN: That's A-3.

21 THE WITNESS: That's in A-3.

22 MR. KEMPLEY: That's right.

23 Q. (BY MR. KEMPLEY) I don't think you'll
24 really need to refer to the conditions to answer my
25 questions, but at least you'll have it open there if

1 you do.

2 Do you believe that creditors currently
3 have any basis to claim that the utilities aren't
4 operated as separate corporate and legal entities?

5 A. Do I believe now that they would have that
6 claim?

7 Q. That's right.

8 A. No. I do not believe that. We pretty
9 much adhere to the appropriate documentation and
10 appropriate separation of functions.

11 Q. Do you think that any creditor believes
12 that it has a basis to feel that way?

13 A. No. I don't, I don't believe so. We've
14 made it pretty much known in the community the
15 restrictions that this Commission has on guarantees,
16 and we have certainly not held ourself out to
17 guarantee anything, nor have we operated these
18 entities to so allow somebody to feel that they had.

19 Q. And you intend to continue that
20 post-merger. Isn't that true?

21 A. Yes, sir.

22 Q. And, in fact, you would agree with me that
23 maintaining that corporate and legal separateness is a
24 very important concept to keep the utilities free from
25 potential problems of commingling of that sort.

1 A. Oh, yes, sir. That's why we've worked
2 with you to get suitable conditions that could be
3 attached to this.

4 Q. And it's your opinion, then, that the
5 condition that you've proposed fully embodies that
6 concept?

7 A. The conditions. I -- did you say
8 condition or conditions? The plural, conditions, yes.
9 There are quite a few that we have worked with you in
10 cooperation to ensure that we can put all the legal
11 separation formally that would appropriately give us
12 ring-fencing, and the companies will always be
13 operated in that regard.

14 Q. And I guess my real question here, kind of
15 the ultimate question, is why you believe that the
16 conditions should stop short of recognizing that
17 degree of separateness in the context of a potential
18 bankruptcy or receiver appointment on the part of one
19 of the non-utility affiliates.

20 A. Can I have that reread, or can you repeat
21 that?

22 Q. I'll try repeating it.

23 The conditions, as I understand them,
24 recognize separation corporate and legally. The
25 condition that the Staff proposes that, as I

1 understand it, the company continues to disagree with
2 is a requirement that would recognize that in the case
3 of a bankruptcy or appointment of a receiver by one of
4 the upstream affiliates, the utilities should not be
5 impacted by that. And it should be reflected in
6 credit agreements from the outset.

7 A. Yes. You're referring to --

8 Q. We call it the bankruptcy condition.

9 A. Yes, sir. We have agreed to all the
10 conditions that are necessary and we have agreed to
11 operate in accord with all the conditions that are
12 necessary.

13 The question comes down to can I guarantee
14 that language can be put in all loan documents from
15 here forward for Saguaro or other entities,
16 non-jurisdictional entities because the Commission
17 still has authority over the terms and conditions of
18 any jurisdictional utility debt offering. And I've
19 been advised that to require the language in the loan
20 documents may create a non-commercial piece of paper,
21 something that is just absolutely not acceptable in
22 the loan documents. Not that the lenders don't
23 understand all this, but it may create a situation --
24 outside attorneys have advised me it may create a
25 situation where you couldn't have any loan. I don't

1 want to get into a problem, once again, I'm
2 guaranteeing something I can't control.

3 The interesting thing about this is the
4 language that has been suggested by your consultant
5 came from TNP. And TNP just completely violated that
6 condition on its documentation going forward because
7 it couldn't get it in the loan documents. And I just,
8 I don't want to be put in that position. We will
9 endeavor, we will make good faith best efforts to get
10 the information and get the material into the loans,
11 but I can't guarantee it. If I can't guarantee it, I
12 don't want to put something down.

13 Q. Sure. Let me ask you just a couple
14 questions, then.

15 Conceptually, you don't necessarily
16 disagree with the condition, it sounds like. With the
17 language.

18 A. Conceptual, I agree that we are going to
19 do everything that is embodied in that condition. I
20 just don't know that it is commercially feasible to
21 get that language into loan documents.

22 Q. With respect to the comments you just made
23 about TNP and violating the condition, do you know
24 what efforts, if any, TNP undertook to get that
25 language that they were ordered to get in loan

1 documents?

2 A. No, I don't. I just know that we had a
3 search of the loan documents and we did not find the
4 language as required by the condition in their loan
5 documents. I don't know what efforts they gave. I
6 can only assure you that we are going to give it
7 everything we can to get it in.

8 Q. And I certainly wouldn't want to put you
9 in a position where you would feel compelled to
10 violate a condition that the Commission had required,
11 but if the condition were required and you found that
12 you were unable to get it in the documents, wouldn't
13 you be able to return to the Commission and seek a
14 waiver of the condition?

15 A. I guess we could always seek waivers of
16 conditions.

17 MR. KEMPLEY: Let me have just a second.
18 That's all the questions I have. Thank
19 you.

20 ALJ RODDA: Thank you, Mr. Kempley.
21 Commissioner Mundell, do you have some
22 questions?

23 COM. MUNDELL: I have a few.

24 Good afternoon. Let me just follow up on
25 one of the questions that's been raised and one of the

1 concerns. You know, we've talked about the fact that
2 management's going to stay in place and the building
3 is going to stay here in Arizona, but we've had, you
4 know, other instances recently in Arizona where we
5 actually have a management team in Arizona and they
6 have buildings here in Arizona but budgetary decisions
7 are made somewhere else, whether it's New York City or
8 North Carolina or Denver or Las Vegas, wherever the
9 budgetary decisions are made.

10 So walk me through the process on -- and
11 you can be the best CEO in the world, but if the
12 budgetary decisions are made somewhere else based on
13 whatever, the priorities the investors make, walk me
14 through the budgetary process, how we're sure that --
15 we have the buildings here, we have the management,
16 but how are we assured that we are going to have the
17 financial wherewithal?

18 THE WITNESS: The -- I was just looking
19 at the stipulations.

20 COM. MUNDELL: I understand you talk
21 about the 1.5 billion. I understand --

22 THE WITNESS: Actually, I was looking at
23 the other stipulations that specifically say
24 management corporate headquarters shall maintain local
25 operations, including employee labor relations, under

1 the supervision of local.

2 The budgetary process as we currently
3 undertake it, and I plan to undertake it in the
4 future, the operation and maintenance budget is
5 prepared and approved at my level. It doesn't go to
6 my board and I do not contemplate it going to the
7 board of the new entity.

8 Capital budgets currently, as I've
9 indicated by our current policy, is that capital
10 budgets require board approval. Further, the
11 commitment to the expenditure of 1.5 billion is based
12 on my budgets that were prepared before this merger.
13 They are consistent with my budgets that I have
14 prepared and which -- when I prepare them, they come
15 up from the organization to me and accumulate at my
16 level. And that 1.5 billion encompasses the, my best
17 judgment of what is necessary to continue to provide
18 at a minimum the same level of service and
19 reliability, taking into consideration that we are
20 upgrading service at UES Electric and Gas because it
21 takes into consideration the upgrades in that system.

22 And that budget, in that 1.5 billion is
23 what I anticipate for the next four years would be
24 necessary to run TEP, UES Electric, UES Gas.

25 COM. MUNDELL: That was going to be my

1 follow-up question, how long is the 1.5 billion --
2 what time period does it encompass, and you answered
3 it by saying four years.

4 So, really, the key issue from a budgetary
5 perspective may be the fifth year and the sixth year
6 and the seventh year?

7 THE WITNESS: Let me retry because it's
8 an average of \$375 million, so I guess that's for five
9 years.

10 MR. HEYMAN: Four.

11 THE WITNESS: Four years. I'm getting --
12 four years. What's the outgoing? Only the assurances
13 that I have that this is going to be operated under my
14 management. I'm going to manage it. I turn 61 this
15 year and I've signed a five-year contract to work
16 through 66. I can give you assurances for at least
17 that five-year period.

18 COM. MUNDELL: I'm really looking
19 further. I understand you're going to be there for
20 five years. I'm trying to understand what the process
21 will be in the fifth year, sixth year, seventh year
22 from a budgetary standpoint. And maybe that's a
23 condition that we may want to discuss further.

24 THE WITNESS: Okay.

25 COM. MUNDELL: Did I understand

1 correctly, I was reading the transcript from
2 yesterday, and you indicated that you were somewhat
3 amazed that the investors, because of regulatory, the
4 time it takes for regulatory approval had, I think you
5 said I'm amazed this investor group has let their
6 capital fallow and stayed on the project for the
7 period of time that it takes to get regulatory
8 approval.

9 What did you mean by that and what did you
10 base that on? Because prior to that, you talked about
11 the cost of crude oil and natural gas.

12 THE WITNESS: Well, the investor group is
13 reinvesting basically pension fund money, money from
14 teachers' funds, some public pension funds. And I
15 don't know the draw down schedules that they have, but
16 essentially, once they committed to this transaction,
17 they committed over a half a billion dollars of those
18 monies which are their responsibility to invest. And
19 the longer the approval process takes, it means that
20 they either have to park this money in short-term
21 securities, if they are drawing it down, but it has to
22 be immediately available upon the consummation of the
23 transaction.

24 And it's, to me, if it's my money, I don't
25 like to hold my capital fallow, or earning a

1 short-term interest rate for an extended period of
2 time waiting for a transaction to be done. They --
3 and it's not -- and it's not a comment on our process.
4 They fully went in understanding it would take -- I
5 told them it would take a minimum of a year. The
6 investors coming into this sector of the market, they
7 have to accept a longer gestation period for their
8 capital. And that amazes me as an investor, as a
9 personal investor, that they can park their money for
10 that long because they have objectives to meet for
11 these pension funds that they are reinvesting.

12 COM. MUNDELL: I understand based on your
13 testimony yesterday that you've talked about this
14 five-year commitment, and you said you had a
15 handshake.

16 THE WITNESS: Yes, sir.

17 COM. MUNDELL: Who did you shake hands
18 with on the five-year commitment?

19 THE WITNESS: I've shaken the hands of
20 Henry Kavis, Scott Stuart, Chris Behrens.

21 COM. MUNDELL: And they have indicated,
22 they've given you their word that even though you
23 don't have a written contract going forward, that
24 you're good for five years.

25 THE WITNESS: Yes, sir.

1 COM. MUNDELL: And I heard your
2 statements why you didn't want to -- well, I think you
3 indicated that it would, from a negotiating
4 standpoint, it would limit your options or may put you
5 in a weaker negotiating position. Is that correct?
6 Having a written contract before we review the final
7 order in this matter. Did I understand that
8 correctly?

9 THE WITNESS: You're correct, sir. I
10 will have mine signed within the next month and
11 presented before the ALJ comes out with her
12 recommendation. I will endeavor to have the others
13 signed as rapidly as possible.

14 The only holdup is the degree to which the
15 other officers want to commit their personal funds and
16 investment. This is all tied in with their employment
17 agreement. We have the term sheets of the investment
18 and I am preparing the proposals that I am going to
19 give to each officer at this point in time.

20 COM. MUNDELL: And I guess from my
21 perspective, and I assume the Commission's
22 perspective, I was more interested in the roles and
23 responsibilities that you're going to have vis-a-vis
24 going forward on management decisions that you
25 verbally talked about and budgetary decisions and

1 input. The monetary stuff, you guys are going to work
2 out. I'm more interested in putting pencil to paper
3 and the roles that you've indicated, the role that you
4 indicated you will have going forward for the next
5 five years.

6 THE WITNESS: That's actually very
7 important, Commissioner, because our change of control
8 documents indicate, and they are in effect right now,
9 if any of us are diminished in our responsibility or
10 position, it triggers a change of control provision.

11 So my contract that I will enter into will
12 specify that I perform the same duties, have the same
13 responsibilities as I currently have. And that will
14 be included in there. And I think, I agree with you
15 it's important that you see that language and I will
16 get that to you.

17 COM. MUNDELL: I think you indicated, I
18 don't know when it was -- time flies when you're
19 having fun, but I think it was earlier this morning
20 when you talked about the ratio of your generation and
21 you were talking about UniSource and TEP and
22 approximately 91 percent is from coal. Is that
23 correct?

24 THE WITNESS: Approximately 90 percent.

25 COM. MUNDELL: And what are the cost

1 projections going forward for coal, the cost of coal?

2 THE WITNESS: Most of our coal is pretty
3 much under contract. Cost for coal in our power
4 plants runs at about, oh, on average, one and a half
5 to maybe two cents a kilowatt hour. And it might
6 escalate at very marginal amounts. It's not the
7 driver in the coal plant. The driver in a coal plant
8 is the recovery of capital and post-operational
9 pollution costs, what we have to, how we have to
10 modify them.

11 The cost in our coal plant, our stranded
12 cost recovery projects that the costs, the average
13 cost out of our assets in 2008 will approximate 3.8 to
14 four cents a kilowatt hour.

15 COM. MUNDELL: Let me shift gears for a
16 second. Let me jump around a little bit. I will try
17 to have this in some order.

18 I think you indicated there's the cost
19 allocation manual. You indicated that, I think
20 somewhere, I read somewhere where you were proposing
21 that you file something post-merger with us. Is that
22 correct?

23 THE WITNESS: Yes, sir. We have an
24 existing cost allocation manual/code of conduct. It
25 depends on what -- it's not the code of conduct that I

1 referred to, it's the actual manual that emanated from
2 our holding company decision that was -- it was
3 provided to the Staff. I think it was approved by the
4 Commission procedures that we were to apply in cost
5 allocation. And the Staff and my staff have been
6 working together to see what needs to be added to make
7 sure that the appropriate codes of conduct are all
8 incorporated, and we have committed to, we will take
9 that manual and conform it to the stipulations and the
10 conditions and get that back within 60 days for your
11 approval.

12 COM. MUNDELL: So I guess the question
13 is, you're asking us to approve it after signing the
14 order approving the merger but within 60 days. Why
15 wouldn't we do it, you know, prior to doing that or at
16 the same time of approving the merger if in fact we
17 approve it?

18 THE WITNESS: You could do it, sir. The
19 existing manual is prepared at your order and
20 utilizing the formulas that you ordered in the
21 UniSource holding company action. I, frankly, think
22 there's very little change necessary in this. I don't
23 want to commit, but I'd give it to you the day after
24 tomorrow if I was in the office. It's something we
25 are prepared to provide you. We are just --

1 COM. MUNDELL: I don't know if there
2 needs to be changes or not. I just, I read that and I
3 said, well, why not do it in a day and a half. If it
4 can be done in a day and a half as you just indicated,
5 I think I would rather see it prior to, you know,
6 voting on any order than afterwards.

7 THE WITNESS: Okay.

8 COM. MUNDELL: Maybe you're not prepared
9 to answer this question. We talked earlier about my
10 question on taxes, and as I understand it, there may
11 be some discussion of that when the panel comes up on,
12 you know, what -- how the post-merger taxes will look
13 compared to currently using -- let's assume for sake
14 of argument all the dollar figures, revenue, expenses
15 are the same if there is any change because of the
16 change in this corporate structure.

17 THE WITNESS: Let me answer two questions
18 here.

19 It's my understanding that property taxes
20 are figured on asset value. That's the basis -- the
21 asset cost. I should put it that way. There is no
22 change in the asset cost as a result of this merger,
23 so property taxes should stay the same. Assuming the
24 same tax rates.

25 With regard to income tax, all other

1 things remaining equal --

2 COM. MUNDELL: State income tax.

3 THE WITNESS: State income tax.

4 COM. MUNDELL: Just to be clear.

5 THE WITNESS: All other things remaining
6 equal with regard to revenue and other expenses, the
7 only thing that I could see change going forward is
8 there will no longer be a loss at Millennium. We have
9 pretty much taken care of that. The cost of debt on
10 our \$400 million bank facility is being reduced
11 approximately two to three hundred basis points, let's
12 say 200 basis points, which would reduce interest
13 costs at TEP by \$8 million.

14 I want to caution you that in our cost of
15 capital, in our rates, that cost of that bank facility
16 is probably still lower than what it is now after this
17 reduction because that -- our rates go back into a
18 time when the cost of that facility was maybe a
19 hundred, 75 to 125 basis points. We got caught in a
20 very narrow market. It went up to 500 basis points
21 and we have brought it back down to about 250 to 300
22 basis points. But that will reduce the interest
23 deduction by eight million.

24 The combination of those two items would
25 increase taxable income by about, approximately, let's

1 say 18 million. However, because we will have
2 approximately \$370 million in debt at the holding
3 company, that interest will be deductible. Let's say
4 that that's an eight percent interest rate on -- let's
5 say 400 million simply because I can do it easier.
6 It's \$32 million in increased interest deduction.

7 So if I take 32 million dollars and I
8 subtract 18 million dollars, I have about a \$14
9 million -- all other things being equal -- reduction
10 in taxable income. And we have about a five percent,
11 I think, corporate tax rate. So five percent of 14
12 million is \$700,000.

13 COM. MUNDELL: Okay. Thank you.

14 Let me -- I guess I'll put this in the
15 record. And it may not be applicable, but I would
16 like the issue addressed.

17 I'm looking at -- and I referred to this
18 earlier today, what is going on in Oregon. And I'm
19 looking at a New York Times article dated June 9th,
20 published June 10th. And I will read it into the
21 record.

22 It says: A state judge has ordered a
23 regulatory hearing to whether Portland General
24 Electric, a unit of Enron, fraudulently collected more
25 than \$665 million from ratepayers to cover corporate

1 income taxes that Enron never paid.

2 That's Enron. It may be unique because
3 they are in bankruptcy. The part of the order that
4 got my attention is this part:

5 The judge's order, made on Friday, comes
6 as a group of Texas investors is trying to buy
7 Portland General Electric under terms that would allow
8 it to collect \$92 million a year for taxes that it
9 would not necessarily have to pay to the federal and
10 state government. The intended buyer, Texas Pacific
11 Group, has said it will not promise to return to
12 ratepayers any taxes it collects but does not have to
13 pay.

14 In all candor, I don't quite understand
15 it, but it raised, it got my attention and I would
16 like it addressed, if not by the panel tomorrow, at
17 some point in time.

18 And then it goes on to say an owner, like
19 Enron, that can earn the 10.5 percent profit on
20 investments set by utility regulators and then pocket
21 the tax money as well could earn more than 20 percent
22 annually on its investment in a utility.

23 So I would like that answered just to make
24 sure going forward, because of the change in the
25 structure here, that that's not going to occur.

1 THE WITNESS: Let me --

2 MR. HEYMAN: Commissioner Mundell and
3 Judge Rodda, before we get to that, because you had
4 raised that earlier, I did discuss that with the
5 investors and they indicated that they are not experts
6 in Arizona tax, that that's something that they would
7 rely upon the company to determine.

8 And so we will -- the company will address
9 that issue and we can do that in the legal brief.
10 Assuming we have a post-hearing brief, we can file the
11 exhibit for you.

12 COM. MUNDELL: I'm also talking about the
13 federal tax law. It says because taxes collected but
14 not paid. And I'm not, I would like the issue at
15 least discussed and delved into a little bit by
16 someone that has an expertise.

17 THE WITNESS: Let me address -- may I
18 address this?

19 COM. MUNDELL: Sure.

20 MR. HEYMAN: It doesn't matter.

21 COM. MUNDELL: You're the client, he is
22 the lawyer.

23 THE WITNESS: I, unfortunately --

24 MR. HEYMAN: Mr. Pignatelli, before we
25 get there, I just want to make clear in the record

1 what it is that you would like us to have briefed so
2 that we can go ahead and address that.

3 You want the issue whether or not a
4 component of rates that is attributable to federal and
5 state taxes is passed on to ratepayers if it is not
6 collected. That's -- is that the issue?

7 COM. MUNDELL: Correct.

8 MR. HEYMAN: Thank you.

9 COM. MUNDELL: And whether the change in
10 this structure --

11 MR. HEYMAN: Would impact --

12 COM. MUNDELL: -- somehow impacts that
13 scenario.

14 MR. HEYMAN: Okay. Thank you. And we
15 will address that in a subsequent document.

16 COM. MUNDELL: If it's helpful, I'll
17 enter this article into the record, have it marked as
18 an exhibit or however you want to do it, just so you
19 know.

20 ALJ RODDA: So you can see.

21 COM. MUNDELL: So you can see what the
22 issue is. I read from it and I tried to go slowly and
23 read --

24 MR. HEYMAN: I think I know which article
25 you are talking about and I have seen a copy of it as

1 well. So I'm keyed in to what you are looking for.

2 MR. KEMPLEY: If I may, Your Honor, we
3 would kind of like to have the article in the record,
4 I think.

5 MR. POZEFSKY: And a copy, too.

6 COM. MUNDELL: I guess this will be
7 Mundell No. 1. We will have it marked as an exhibit.
8 As long as she admits it, I guess we are okay.

9 MR. KEMPLEY: I've never seen a
10 Commissioner exhibit that wasn't admitted.

11 COM. MUNDELL: There is always a first.

12 THE WITNESS: Commissioner, if I may,
13 this is a long-standing confusion in regulated
14 businesses. I can't say exactly what components
15 contributed to what they are contending there. I can
16 say that we establish rates based on income taxes with
17 deferred taxes in them. In other words, there is a
18 difference in timing of the deductions. And at times,
19 at any one point in time, it may appear that more has
20 been collected because it is owed to the federal
21 government in the future than has actually been paid
22 because of the "levelization" caused by normalized, or
23 deferred tax accounting.

24 I can tell you that we have always -- and
25 it's been, I believe with the approval of the Staff,

1 had a tax-sharing agreement which provides that the
2 utilities will only pay the tax attributable to their
3 operations. And if there are taxes which result from
4 non-jurisdictional properties, or tax reductions
5 because of losses at non-jurisdictional, that those
6 stay in those, they are allocated to those
7 non-jurisdictional assets.

8 But the taxes paid versus the taxes
9 collected at any one point in time is most likely
10 different because of deferred tax accounting because
11 of the tax deductibility of items for federal and
12 state income tax purposes in different periods than
13 they are for regulation.

14 COM. MUNDELL: And, Mr. Pignatelli, I
15 appreciate that answer. I want to be clear of what
16 benefits, if I can use the word, that, you know,
17 everyone is receiving because of this transaction,
18 whether it's tax benefits, whether it's different
19 types of depreciation. Those are sort of the big
20 picture here from my perspective.

21 THE WITNESS: The transaction results in
22 no difference in depreciation. It only results in an
23 interest expense which produces a tax benefit at
24 UniSource.

25 COM. MUNDELL: Thank you.

1 THE WITNESS: But the jurisdictional
2 entities, TEP, UES Electric and UES Gas, do not pay
3 that interest expense nor get the benefit of that
4 interest deduction on the tax returns.

5 COM. MUNDELL: Thank you.

6 Shifting gears, you used some pretty
7 strong language yesterday when I think RUCO was asking
8 questions. Naive, I think you said, duplicitous,
9 really questioned the motives, suggesting that it
10 might be important to know whether or not the company
11 is over earning or not before we make a decision on
12 this matter.

13 And I wasn't clear by your answer whether
14 or not you had had an opportunity to read the Staff's
15 answer to my question on that issue of over earning.

16 THE WITNESS: I am aware of Staff's
17 answer wherein they indicated that our after-tax
18 returns were certain amounts and then indicated
19 immediately if those were adjusted for the
20 hypothetical capital structure, those return on equity
21 estimates go down to what is under our authorized
22 return.

23 So I thought that the Staff was very fair
24 in their presentation and showed you the actual RO,
25 the ROE on our actual equity, but realized that for

1 rate-making purposes, we look at the return on equity
2 on the hypothetical capital basis.

3 So I thought that their presentation and
4 discussion was fair and balanced because it reflected
5 at least an appropriate adjustment for
6 jurisdictionalizing this equity.

7 COM. MUNDELL: So to use those words
8 naive and those other descriptions, you were referring
9 to whom and under what circumstances?

10 THE WITNESS: Those were directed at RUCO
11 because I felt that the presentation was less than
12 complete. It did not take into any consideration any
13 jurisdictional allocations. It was on a pre-tax
14 basis. And if memory serves me, there were four or
15 five other deficiencies.

16 I'm trying to find the paper here that I
17 had yesterday wherein I had those delineated. But
18 there were four or five things that should have been
19 adjusted for in any cursory examination and I
20 personally felt offended that they hadn't been
21 considered.

22 COM. MUNDELL: Well, I guess your answer
23 at least sort of illustrates the dilemma that
24 reasonable people acting in good faith might assume
25 that it would be important to know whether or not TEP

1 is over earning. In fact, Staff said at first blush
2 it may appear that TEP may be over earning, and then
3 they go on to have some caveats.

4 So we can argue here whether you are or
5 aren't, and the facts will speak for themselves, but I
6 guess the problem I have is the adamant position that
7 it's not important for the Commission or at least this
8 Commissioner to have that information before I make a
9 decision on this merger application.

10 THE WITNESS: I think that to fully
11 discuss and be satisfied that all confusions about any
12 numbers and all differences of opinion about any
13 numbers in a complex rate matter could be accomplished
14 in a time consistent with adjudicating this
15 authorization for new shareholders to buy our existing
16 shares would delay this process to an extent that the
17 deal would collapse.

18 COM. MUNDELL: Let me address that. I'm
19 going to have some questions on some of the provisions
20 of the merger document.

21 But before I get there, as I understand
22 it, the investors originally wanted the, to have one
23 proceeding, and management, including yourself,
24 suggested they be bifurcated.

25 Isn't that correct?

1 THE WITNESS: Yes. We felt a bifurcated
2 process because we firmly believe that, one, the
3 standard in determination of the change in ownership
4 of a non-jurisdictional affiliate was fairly well
5 established and did not include a review of current
6 terms and conditions of service.

7 COM. MUNDELL: So reasonable people,
8 without being naive or duplicitous, could reach the
9 conclusion that it would be perfectly appropriate to
10 have one proceeding. I mean, investors wanted to do
11 that initially and you all suggested otherwise.

12 THE WITNESS: I never implied that the
13 naive or duplicitous went to bringing the two
14 procedures together. I stated that the naive and
15 duplicitous was a cursory review which said a rate
16 reduction was appropriate.

17 COM. MUNDELL: Let me talk about the time
18 line. What is the time line from your perspective in
19 this application?

20 THE WITNESS: The time line in this in my
21 perspective is the conclusion of these hearings this
22 week; an ALJ recommended order in -- well, through a
23 briefing period, an ALJ recommended order in
24 approximately six weeks; and a Commission open meeting
25 within 30 to 60 days thereafter.

1 COM. MUNDELL: I didn't ask the question
2 very well.

3 When do you anticipate closing if that
4 time frame were to occur?

5 THE WITNESS: If that time frame was to
6 occur, we would close probably within a month after
7 the decision, just waiting for the appeal, any
8 appropriate appeal period, and we would close the
9 transaction.

10 COM. MUNDELL: As I understand it, the
11 financial commitments will expire in February of 2005.
12 I don't know the exact date, February 25th or
13 something?

14 THE WITNESS: I thought it was March 1st,
15 but I --

16 COM. MUNDELL: Well, in any event --

17 THE WITNESS: It's within the first
18 quarter. That's true.

19 COM. MUNDELL: I guess that goes back to
20 the question of trying to get a little more
21 information on whether or not the company is over
22 earning. It seems to me we have some time to delve
23 into that prior to making a decision here if those
24 financial commitments don't expire until, you know,
25 February 25th of 2005.

1 THE WITNESS: Sir, you have -- we have
2 filed the information.

3 COM. MUNDELL: Okay.

4 THE WITNESS: How expeditiously the
5 Commission wants to provide a rate check is at your
6 disposal, not at mine. We have filed the information,
7 we have had discussions with Staff about filing
8 additional testimony. I don't know the Staff's
9 workload nor the Commission's workload.

10 COM. MUNDELL: So as I understand that
11 answer, then, if we were to make, we meaning the
12 Commission or the Commissioners, make that a priority,
13 you would certainly cooperate in that endeavor and we
14 could get the answers that seem to be -- where there
15 seems to be a difference of opinion?

16 THE WITNESS: I would always cooperate.
17 I don't think it is appropriate to combine the two,
18 and I so indicated that yesterday in answer to some
19 questions.

20 COM. MUNDELL: As I understand it,
21 looking at the minutes -- let me strike that.

22 When were you first contacted by the
23 investor group in this matter to purchase UniSource?

24 THE WITNESS: Someplace up here, I have a
25 time line. If you will indulge me, I have so much

1 paper.

2 COM. MUNDELL: I can ask another question
3 while someone tries to find that.

4 THE WITNESS: Can I ask that time line be
5 brought to me? I have it up here; I just can't find
6 it.

7 MR. HEYMAN: If I may.

8 THE WITNESS: Thank you. I have a time
9 line in front of me that indicates on July 19th, 2002,
10 we signed a confidentiality agreement with the J.P.
11 Morgan group. They would have approached us prior to
12 that and we would have taken a little bit of time to
13 negotiate a confidentiality agreement. So it had to
14 be sometime in the summer of 2002.

15 COM. MUNDELL: And did that
16 confidentiality agreement prohibit you from informing
17 the Commission about that inquiry? That contact?

18 THE WITNESS: I don't know the -- I don't
19 have a recollection of the prohibitions on who we
20 could discuss it with. I would doubt that it
21 specified that we could not talk to the Commission,
22 but I don't know the intent.

23 COM. MUNDELL: Well, I assume you'll make
24 a copy of that available for us.

25 THE WITNESS: Certainly.

1 COM. MUNDELL: And I think I know the
2 answer to this, but just so it's clear, the UniSource
3 Gas and UniSource Electric subsidiaries are part of
4 this transaction. Is that correct?

5 THE WITNESS: That's correct.

6 COM. MUNDELL: Let me just, let me read
7 to you -- I'm looking at the transcript from the
8 Citizens-UniSource purchase dated May 1st, 2003,
9 volume one, page 95, where you're being asked
10 questions by Mr. Holla. I think he represented the
11 city of Nogales.

12 And the question is: Have you had any
13 discussions with anybody about selling any portion of
14 these assets after you get approval from the
15 Commission to take them over? Your answer: Yes, you.
16 And the follow-up question is: Anybody else? And
17 then your answer is no.

18 THE WITNESS: That's correct.

19 COM. MUNDELL: Correct meaning what?

20 THE WITNESS: I recall that exchange and
21 I would still answer today the same way. And I'm not
22 selling any of these assets to any other group.
23 What's happening in this transaction is that a group
24 of investors are buying my stockholders.

25 COM. MUNDELL: So when the word selling

1 was used in that question, you interpreted it very
2 narrowly and answered it that you had no discussions
3 with anyone to sell them? Is that what you're saying
4 here today?

5 THE WITNESS: No. The question was have
6 you had any discussions to sell any of these assets,
7 and that answer would still be the same. If I
8 contemplated that to involve stock, I would have had
9 to say yes because I sell stock every day. I mean,
10 stock is traded every day. I'm sorry, I don't think I
11 took a narrow view of that.

12 COM. MUNDELL: Okay. Well, as you
13 recall, one of the issues was, in that matter was the
14 concern about whether there was anything in the works
15 and there were some pleadings to that effect. And
16 you're saying that the way you answered that wouldn't
17 lead anyone to conclude that there might have been
18 negotiations that we're currently talking about here
19 today.

20 THE WITNESS: There weren't any
21 negotiations, honestly, at that time, either.
22 Because --

23 COM. MUNDELL: The word said had any
24 discussions.

25 THE WITNESS: In November, we terminated

1 all discussions. And that was prior to us acquiring
2 the Citizen transactions, or completing the Citizens
3 transaction.

4 COM. MUNDELL: Okay. Let's talk about
5 the waiver issue just for a second.

6 As I understand your testimony from
7 yesterday, you've agreed now that you're not taking
8 the position the waiver should stay in place but it's
9 sort of the same issue, you want some time to work on
10 those or file post-approval by this commission? Did I
11 understand your testimony yesterday to imply that?

12 THE WITNESS: Yes. I only am asking that
13 the waiver stay in place until the Commission, until
14 we file with the Commission for new waivers and the
15 Commission acts on that. If you want me to file for
16 new waivers next week, we'll file for new waivers next
17 week so you can act on that, also. I'm trying to be
18 cooperative in this.

19 COM. MUNDELL: No, I understand. And --
20 well, your first position was they -- you say you're
21 trying to be cooperative and I understand we have a
22 lot of conditions, but the first position was that the
23 waivers should stay in place. The current waiver
24 should stay in place post-merger, correct? That was
25 the company's first position?

1 THE WITNESS: No. That's incorrect.

2 COM. MUNDELL: Okay. I misunderstood,
3 then.

4 THE WITNESS: It was that the waivers, to
5 the extent that they were different from these
6 conditions, should stay in place. But these
7 conditions should replace all of the preexisting
8 waivers. And the Staff just wanted us to come back
9 and clean up and get rid of the waivers that were no
10 longer applicable because of being superseded by this.

11 And all I'm saying is I'm more than happy
12 to do that; I just want the existing waivers to remain
13 in place until the Commission acts on the new waivers.

14 COM. MUNDELL: Well, again, just speaking
15 for myself, I would like to have the chance to review
16 the waivers prior to, or at the same time as we review
17 this application.

18 THE WITNESS: Certainly.

19 COM. MUNDELL: You talked about, and
20 clarified, where the 1.5 billion would be spent. How
21 much has been spent on system reinforcement for
22 UniSource Electric over the last -- how much do you
23 anticipate will be spent over the next two years?

24 THE WITNESS: I'll have to give you that
25 information. I don't have the exact numbers. I can

1 tell you what we have done, but I can't tell you the
2 cost of that that we have incurred or that we
3 anticipate.

4 COM. MUNDELL: Is that included in the
5 1.5 billion?

6 THE WITNESS: Yes, sir.

7 COM. MUNDELL: It is included in that?

8 THE WITNESS: Yes.

9 COM. MUNDELL: Okay.

10 THE WITNESS: Do you want me to testify
11 as to what we've done?

12 COM. MUNDELL: You can. I don't know if
13 you had it there. Obviously, you are ready to answer
14 the question, so --

15 THE WITNESS: Okay. I haven't found it
16 yet, so --

17 COM. MUNDELL: You haven't?

18 THE WITNESS: Actually, I have.

19 COM. MUNDELL: That's why I was going to
20 move on and then go back to it.

21 THE WITNESS: Well, there is one thing
22 that I want to assure you, Commissioner, and assure
23 the Intervenors from UES and others, that we have put
24 in automatic closers, we have put in bird guarding, we
25 have added two additional crews, we have upgraded

1 equipment for faster response, we have required
2 material standards for better response.

3 Now, we have had no outages on that system
4 this year. On our system. There have been two caused
5 on the WAPA system. We have had none. Now, I would
6 like to take a lot of credit for that, but the main
7 interruptions in those systems is during storm season,
8 which we are just getting into. And I haven't found a
9 way to really protect those systems from lightning and
10 from wind. We just are trying to accelerate response
11 times and minimize overall incursions, but we have
12 undertaken, we take with a great deal of sincerity and
13 responsibility our, improving our reliability in those
14 territories and we will continue to do so, and the
15 costs associated with that are included in the 1.5
16 billion.

17 COM. MUNDELL: Thank you.

18 Now, you indicated -- and I want to
19 understand the thinking when the merger agreement was
20 signed. You talked about negotiating with a gun to
21 your head yesterday. You wanted to have some ability
22 to negotiate your contract going forward, your
23 employment contract going forward that you talked
24 about earlier.

25 Why did you all agree to the \$25 million

1 breakup fee if -- in the merger?

2 THE WITNESS: People who negotiated that
3 deal, which was the strategic committee, upon advice
4 of counsel, outside counsel, determined that the \$25
5 million breakup fee was within the market and
6 appropriate. Now, that breakup fee, that \$25 million,
7 it's my understanding -- and I was not part of this
8 negotiation. That \$25 million is only payable if
9 there's a topping offer, if the company is sold to
10 another party as opposed to these parties within, from
11 now and for a 12-month period.

12 And it's my understanding that that is a
13 standard in the industry, and that is a shareholder
14 risk in any event.

15 COM. MUNDELL: That is a shareholder
16 risk?

17 THE WITNESS: That's correct, sir.

18 COM. MUNDELL: What about the issue of if
19 there isn't regulatory approval on the expenses of the
20 investors? Who pays that?

21 THE WITNESS: There is a cap. My
22 recollection is about \$8 million, and that's a
23 shareholder risk, sir.

24 COM. MUNDELL: And that was agreed to --
25 I know there was a lot of discussion back and forth in

1 the minutes on whether that should be agreed to or
2 not. But, again, you're saying that was based on a
3 recommendation of the strategic -- the swat team or
4 whatever it's called and their independent counsel?

5 THE WITNESS: Yes, sir. The board formed
6 a strategic group made up of all independent
7 directors. I was not a party to it. They hired
8 separate legal counsel and separate investment
9 advisors, and they negotiated a transaction --

10 COM. MUNDELL: I thought I read somewhere
11 in there that you originally said both sides should
12 pay their own expenses. I would have to find it in
13 the minutes. So that's why I'm confused by your
14 answer that you weren't involved in that process. But
15 I'll try --

16 THE WITNESS: I was not involved in the
17 process. It's always my recommendation. I used to
18 say when I was doing transactions, that we always
19 started out with the agreement we would bury our own
20 dead. That's not necessarily the way that large
21 mergers and acquisitions are done. But I did not.
22 That was my recommendation. It was obviously
23 inappropriate.

24 COM. MUNDELL: Okay. I understand the
25 distinction now, I think. You made a recommendation

1 in one of the board meetings, but your recommendation
2 was not followed? Is that what I'm understanding now?

3 THE WITNESS: That's correct.

4 COM. MUNDELL: Okay. And this may be a
5 question more appropriate for the panel. Going
6 through all the fees that are going to be paid to the
7 different entities, because your answer -- when I say
8 your answer, your company's answer was, when I asked
9 the question about fees, the answer was -- talked
10 about standard fees, and it says however, the
11 investment firms associated with the limited partners
12 will charge customary transaction and advisory fees.
13 And I put a note to myself, what are they. I mean,
14 that's a great answer, but what is the total -- I'm
15 trying to get a dollar figure here to understand who
16 is getting what in this transaction.

17 THE WITNESS: I think you'd be better
18 served by asking those --

19 COM. MUNDELL: Okay.

20 THE WITNESS: Once again, I want to
21 assure you that none of that will ever find its way
22 into cost of service.

23 COM. MUNDELL: I understand that. But
24 that's a different issue than, at least from my
25 perspective, about who is making what in this

1 transaction and, you know, is it a fair transaction to
2 everyone involved, including the ratepayers.

3 There is a lot of immediate benefits --
4 and that's more of a question. There are a lot of
5 immediate benefits, I will ask it in a question form,
6 to a number of entities and individuals.

7 Would you agree with that?

8 THE WITNESS: Yes.

9 COM. MUNDELL: You indicated that there
10 are no planned layoffs and I wrote a note to myself,
11 by you, by your management team, by the investors?
12 What did you mean by that?

13 THE WITNESS: There are no planned
14 layoffs by any of the above. The investment team --

15 ALJ RODDA: I'm sorry?

16 THE WITNESS: I'm running the company.
17 The investment team has not asked me for layoffs or
18 anything else and they know I would bridle at that. I
19 just said there are no planned layoffs, and the reason
20 why I carefully say there will be no terminations and
21 things like that is because I always think it's my
22 obligation to seek more efficiencies and I never want
23 to feel that my employees all feel that they have
24 guaranteed employment because that would be the worst
25 thing that could happen for safety and reliability of

1 service.

2 COM. MUNDELL: You want to take a break?

3 ALJ RODDA: Yes. Let's take a ten-minute
4 break here.

5 (A recess ensued.)

6 ALJ RODDA: Let's get started again.

7 During the break, I had copies made and an
8 exhibit of Mundell-1, which was the article, marked.
9 And I gave out copies to some of you, but I have
10 additional copies up here. So after the proceeding,
11 those of you who haven't gotten copies of Mundell-1
12 and want one can get one.

13 And I think our plan, as much as we can
14 plan in this proceeding, is to finish up here with
15 Mr. Pignatelli and then start with Mr. Stuart and the
16 panel, get them sworn in, some foundation laid and
17 some cross-examination. There's a couple of the
18 Intervenors who I know had some limited
19 cross-examination of the panel, if we can see if we
20 can get through those Intervenors today and then
21 continue on into the morning. So that's the plan, at
22 least. We will probably maybe go until 6:00 or so.

23 THE WITNESS: I thought you meant
24 continue on right into the morning.

25 ALJ RODDA: Okay. Let's take a vote.

1 COM. HATCH-MILLER: No.

2 ALJ RODDA: Looked like some good storm
3 action heading our way, so that's maybe good news.

4 So, Commissioner Mundell, do you have some
5 additional questions?

6 COM. MUNDELL: I do, thank you.

7 I think we left off, I had asked you about
8 any planned layoffs, and you answered that question,
9 but I just want to have you explain. I'm looking at
10 the minutes from November 18th, I guess November 18th
11 of 2003 --

12 THE WITNESS: Could I request it be
13 brought to me? Is it the board or the strategic --

14 COM. MUNDELL: It's the board meeting.
15 No, let me make sure. No, I'm sorry. It's the
16 UniSource, it's the strategic advisory committee,
17 Transaction Advisory Committee, November 18th, page
18 18.

19 MR. HEYMAN: Commissioner Mundell, the
20 Unisource Energy Corporation minutes, excerpts of the
21 special meeting, board of directors? Is that --

22 COM. MUNDELL: No, the transaction
23 advisory committee, November 18th, held at 8:30 a.m.,
24 page 18.

25 MR. HEYMAN: Your Honor, is it okay if I

1 just look over the witness's shoulder for a bit?

2 THE WITNESS: I have that in front of me,
3 sir.

4 COM. MUNDELL: Let me read you the
5 sentence:

6 Mr. Pignatelli stated that most of the
7 workforce will be protected and the bargaining units
8 will be retained as a result of the proposed
9 transaction.

10 So I guess the question is, what does that
11 mean, most of the workforce will be protected? You
12 can read it inversely. If most of it will be
13 protected, then some of it would not be. What does
14 that mean?

15 THE WITNESS: It means that there is no
16 desire nor intention to cause any layoffs; that
17 workforce management will be at my discretion and that
18 I would plan to utilize or increase the current
19 workforce. But I always caveat anything, and the
20 reason most of the workforce will be protected is
21 simply my overabundance of caution and not desiring
22 anybody to believe that they have a fixed employment
23 for life.

24 COM. MUNDELL: Thank you.

25 One of the -- I'll try to paraphrase it.

1 Correct me if I'm not understanding.

2 One of the arguments that's been put forth
3 as I understand it is that because of the size of
4 UniSource, it is ripe for being purchased by someone.
5 Is that correct?

6 THE WITNESS: That's correct. The size
7 of UniSource, it doesn't get the following in the
8 investment community, analysts, limited analyst
9 coverage, which causes, in my opinion, UniSource to be
10 not fairly valued which then gives the opportunity for
11 other parties to see that it is a profitable
12 acquisition.

13 COM. MUNDELL: And as I understand, a
14 market test was performed in this particular matter?

15 THE WITNESS: Yes, sir. The Strategic
16 Transaction Advisory Committee had their independent
17 advisor make calls to various potential investors.

18 COM. MUNDELL: And as a result of that
19 market test, there were no takers? Is that correct?

20 THE WITNESS: There were none prepared to
21 come in and offer the equivalent purchase price. Some
22 were interested, but they said not at that price
23 level. That's my understanding. I was not a party to
24 those.

25 COM. MUNDELL: I'll ask you the question.

1 Your counsel filed a response and I had asked for a
2 number of documents concerning meetings between
3 UniSource management and members of the investor group
4 and copies of all presentations, and I listed a number
5 of different meetings. And the answer that I got back
6 was there are no minutes of meetings between UniSource
7 Energy management and members of the investor group
8 for the meetings on the above-referenced dates.

9 And, so, November 2nd, 2002, July 14th,
10 2003, July 30, 2003, September 9th, 2003, September
11 16th. So am I to understand that there's no, there
12 was no presentations? And part of my question was no
13 presentations, no minutes, no notes, no nothing of
14 those meetings?

15 THE WITNESS: I have no knowledge of --

16 COM. MUNDELL: Maybe I'm reading it
17 wrong.

18 It's page eight of your response,
19 Mr. Heyman. I may be reading it wrong.

20 MR. HEYMAN: Yes. Commissioner Mundell,
21 my understanding is that we did provide you with some
22 presentations in response to your request, but there
23 were no minutes like there were board minutes or the
24 STAC minutes. So you do have some presentations that
25 were presented by the parties that were attending,

1 either the company or the investors.

2 COM. MUNDELL: So those presentations,
3 those presentations are from those, the meeting
4 between the UniSource management and the investor
5 group as opposed to the Strategic Transaction Advisory
6 Committee?

7 MR. HEYMAN: Well, I would have to know
8 which ones you are talking about because there may be
9 some carryover. But I just didn't want to leave you
10 with the impression that we didn't provide you with
11 presentations between those two groups.

12 COM. MUNDELL: I misunderstood, then. I
13 will look at those this evening and maybe have some --
14 as I understand, Mr. Pignatelli may come back at the
15 end of this hearing, correct?

16 THE WITNESS: Yes.

17 COM. MUNDELL: But it still goes to my
18 question. There's no minutes, no notes, they are not
19 tape recorded, there is nothing for us to look at?

20 THE WITNESS: No, I would anticipate that
21 those were probably due diligence meetings and there's
22 no record kept of those discussions. Those are just
23 open-ended discussions and there are no tape
24 recordings.

25 COM. MUNDELL: Okay. And I think it's

1 page -- this actually makes it fairly easy. On page
2 ten of those, that same November 18th meeting -- I'll
3 find my notes here.

4 THE WITNESS: Yes, sir.

5 COM. MUNDELL: There was a presentation
6 by Mr. Moore, discussed the preliminary conclusions of
7 Morgan Stanley on the evaluation of the company and
8 presented some financial analysis to the committee.

9 Has that analysis been provided to our
10 staff and whatever conclusions Morgan Stanley reached
11 on the valuation of the company? Has that ever been
12 provided pursuant to a data request or anything else?

13 THE WITNESS: It's my understanding it
14 has.

15 COM. MUNDELL: It has?

16 MR. HEYMAN: Commissioner Mundell, again,
17 that was pursuant to a protective agreement.

18 COM. MUNDELL: Okay. Well, I guess from
19 my -- we don't see everything. That's one of the
20 problems. We don't see everything that's exchanged
21 between the parties. And that's always a quandary.
22 So I don't know who to --

23 MR. HEYMAN: Let me help you. On page
24 eight of our response, what you had referred to
25 before, the first item that's listed --

1 COM. MUNDELL: What are those, Bates
2 numbers?

3 MR. HEYMAN: Correct.

4 COM. MUNDELL: Okay. Which one?

5 MR. HEYMAN: Page eight, it says see
6 Bates number UEC00004443 to 4495, Morgan Stanley
7 presentation. That's in connection.

8 COM. MUNDELL: Okay. Because the other
9 one says November 18th minutes and that's what I was
10 confused about. You see where it says minutes of the
11 meetings of the Strategic Transaction Advisory
12 Committee meeting, see Bates number blah-blah-blah for
13 November 18th minutes.

14 But you're saying it's included in a
15 different one? Just so I understand.

16 MR. HEYMAN: You know what, I'm getting a
17 little bit of help here from Mr. Nitido. Not much,
18 though.

19 If you don't mind, Judge, what I can do,
20 if we can start on page seven --

21 COM. MUNDELL: Okay.

22 MR. HEYMAN: -- what I would do is take
23 it from the top of the page. And you'll notice, the
24 first entry does refer to a management presentation to
25 JPMP Group. That will help for the thing we were

1 talking about before.

2 COM. MUNDELL: I see. It's on the top
3 of -- I see. Thank you.

4 MR. HEYMAN: And then, if you go two
5 down, it says New Harbor Incorporated presentation.
6 And then if you go to the next one, it says "Theland,
7 Reed and Priest" presentation. So if you look on that
8 page, that will indicate where the presentations are.

9 COM. MUNDELL: That helps quite a bit
10 because when I saw this, I --

11 MR. HEYMAN: It may not have been broken
12 out precisely the way you were anticipating, but
13 hopefully the Bates stamp numbers will help match
14 things up.

15 COM. MUNDELL: It does. Thank you.
16 And then I guess the same question, then.
17 There is, in one of those Bates numbers, there is a
18 forecast on the rate of return for the buyers?

19 MR. HEYMAN: Correct.

20 COM. MUNDELL: Which one is that? Would
21 you point that out for me?

22 MR. HEYMAN: For the process of time, let
23 me do that --

24 COM. MUNDELL: Later? I've only got a
25 few more questions.

1 Mr. Pignatelli, I think Mr. Magruder was
2 asking you about distributed generation. I'll ask you
3 a quick question because you said you believed you
4 were concerned about some of costs, as I understand
5 your testimony. Is that correct?

6 THE WITNESS: Yes, sir. I don't believe
7 that distributed generation is brought in to be cost
8 effective yet.

9 COM. MUNDELL: Has the company taken a
10 position on, the one that's downtown here, right
11 across, the distributed generation facility that
12 provides power I think to the police department and
13 fire department?

14 THE WITNESS: We support it. We back it
15 up. We didn't fight the transaction. We advised the
16 city we didn't think it was needed. They determined
17 that they were going to make the investment and we
18 provide backup supply to insure that the safety
19 systems have adequate systems if it fails.

20 COM. MUNDELL: To be clear, do you
21 support expansion of it? It's 1.6 megawatts right now
22 as I understand it. Do you support expansion of it?

23 THE WITNESS: I support appropriate
24 expansion if it is cost effective. I don't like the
25 city spending money which I don't think is cost

1 effective.

2 COM. MUNDELL: So the key word is
3 appropriate and cost effective?

4 THE WITNESS: Yes, sir.

5 COM. MUNDELL: Okay. I think I'm done.

6 Thank you.

7 ALJ RODDA: Okay.

8 Commissioner Hatch-miller?

9 COM. HATCH-MILLER: Does this still work,
10 even with these little cups on? So much for that
11 idea. All right. Now we know.

12 Hi, Mr. Pignatelli.

13 THE WITNESS: How are you today, sir?

14 COM. HATCH-MILLER: I'm good. I had a
15 chance to come up with a few questions and I want to
16 ask one or two.

17 THE WITNESS: Okay.

18 COM. HATCH-MILLER: Thank you, Your
19 Honor.

20 Does the \$25 million breakup fee apply if
21 the Commission doesn't approve the transaction?

22 THE WITNESS: No. That's more of a
23 topping fee. The only fee, breakup fee would be cost
24 to a maximum, and I believe it's around eight million
25 dollars.

1 COM. HATCH-MILLER: Say that again.

2 THE WITNESS: It would be the investors'
3 costs to a -- their actual costs to a maximum of, and
4 I think the number is around eight million dollars.

5 COM. HATCH-MILLER: That you would owe
6 them.

7 THE WITNESS: Yes, sir. UniSource --

8 COM. HATCH-MILLER: Not you, personally,
9 but --

10 THE WITNESS: Correct. Yes, sir.

11 COM. HATCH-MILLER: So, if so, that eight
12 million dollars, would TEP, UniSource, UES or one of
13 those entities attempt to recover that eight million
14 dollars in a future rate case proceeding?

15 THE WITNESS: No, sir. It's a cost to
16 the shareholder.

17 COM. HATCH-MILLER: Those are the two
18 questions I had. Thank you, Your Honor.

19

20 EXAMINATION

21

22 Q. (BY ALJ RODDA) I think, after a full day,
23 most of my questions have been answered, too, and
24 probably even the questions I'm going to ask you are
25 somewhere in the record. But I don't know where.

1 So, when you first, I think it was
2 yesterday, you testified to the fact that you believe
3 that, you believe you saw shrinking financial
4 resources for TEP if this transaction were denied.
5 And I'd just like you to tell me, what do you mean by
6 that, by shrinking financial resources and why is that
7 absent in this transaction?

8 THE WITNESS: It's somewhat of a
9 comparison between with and without the transaction.
10 TEP would have \$165 million less in equity. It would
11 not have the \$95 million note paid off. So,
12 consequently, it would have about 270 million in debt
13 that exists today but would be over and above if this
14 transaction was approved. We would have the same
15 essential capital structure that we have now. We
16 would have essentially the same non-investment grade
17 ratings that we have now.

18 Competition for debt for companies our
19 size and for, with our ratings is very difficult. The
20 debt markets are thin and open and closed. The best
21 example that I can give is when we were forced to
22 renew our 400 million line of credit which backs our
23 tax-exempt floaters about a year and a half ago or so,
24 it cost us a five hundred basis point cost just for
25 the banks to guarantee the floaters. That had

1 previously run about one percent, but we got caught in
2 a market that was a lot of competing utility
3 financings undergoing and those markets get thin and
4 very pricey.

5 So, initially, as I just indicated I
6 believe in an answer to Commissioner Mundell, we see,
7 with the change in investment advisory services,
8 there's been kind of an evolution or revolution in
9 Wall Street where the investment houses have much
10 fewer analysts. There are fewer and fewer analysts,
11 and we have, at this point in time, only one equity
12 analyst that covers our stock. So we have very
13 limited exposure and I see it getting less and less
14 vis-a-vis our equity. So, we would be forced to
15 access equity markets which don't know, don't
16 understand the company, which would cause our
17 effective cost of capital to be increased. I have
18 fewer sources of capital.

19 For example, in the UES acquisition of UES
20 Gas and Electric, we actually had to borrow the bridge
21 until we could close another transaction to get the
22 equity, and we had to borrow, the 60 percent we
23 borrowed, we had to go to insurance companies. And
24 the terms are very difficult, very short term,
25 three-year notes, five-year notes, and it's just very

1 difficult for this company to continue -- it's a
2 struggle day in, day out.

3 We have actually been benefitted because
4 of deregulation and we didn't have the need to build
5 generation. That, there seems to be a change in that
6 environment which is going to cause us to have more
7 and more capital needs.

8 This merger, by increasing our equity,
9 allowing us to reduce our debt, makes us financially
10 more healthy as a utility. But, additionally, it
11 opens a whole new source of capital to us and a whole
12 new strength in the capital market. The 400 million
13 that we indicated we struggled to get renewed and had
14 to pay over 500 basis points, we just renewed for
15 approximately two and a half basis points. 250 basis
16 points. I'm sorry.

17 Now, part of that was that the market
18 improved and part of it was because these investors
19 brought a broader group of lenders. And rather than
20 having a three-year letter of credit with a 364-day
21 revolving credit line, we have a five-year letter of
22 credit. We have better terms and conditions. And we
23 don't have the 364-day revolving credit. I was forced
24 to be back in the market every day for my revolving --
25 for my letters of credit.

1 Additionally, one additional point I think
2 is important to note, we also, as a result of these
3 lenders' participation, have been able to arrange a
4 \$40 million letter of credit revolving for UES. That
5 had no supplemental liquidity. And as a result of
6 these investors' participation and a broadening of the
7 market available to you through their ability to help
8 us, it has expanded, it has already, will increase
9 liquidity and capital available at UES Electric and
10 Gas; it's providing me better terms and conditions on
11 my base 400 million letter of credit that backs my tax
12 exempts.

13 Q. When you say with the participation of the
14 investors you were able to get a better deal on the
15 refinance of your \$400 million facility --

16 A. I believe so.

17 Q. -- was that because they are somehow
18 involved in that credit, or the market was looking at,
19 oh, this is in the works, or what?

20 A. They were involved with us in that because
21 they, at the same time, went out and got commitments
22 on some of their capital requirements and it brought a
23 much broader basis. They have to come up with \$1.2
24 billion when the transaction closes, and they have
25 secured commitments on a significant portion of that,

1 and they did it at the same time we were out with our
2 400. And the combination, they brought a much larger
3 pool of capital to the table through their concerted
4 efforts. Much larger than I have been -- it expanded
5 the lenders to TEP quite a bit.

6 Q. So, even with all these benefits to TEP,
7 that level of the organization, I'm taking it from
8 Staff's testimony that Standard and Poors still, I
9 don't know, put them on the watch list or viewed it
10 rather negatively. What was going on with Standard
11 and Poors?

12 A. Standard and Poors put us on the negative
13 credit watch. They did the same thing, I think APS is
14 on negative credit watch by Standard and Poors, too,
15 until the completion of the rate proceedings.

16 Standard and Poors takes -- we were put on
17 negative watch when we announced the UES Electric and
18 Gas acquisition. It's sort of a normal course.
19 However, Standard and Poors has a tendency to have
20 limitations on the spread between the ratings of a
21 consolidated holding company and the ratings it will
22 provide the individual subsidiaries. That's also,
23 honestly, why maybe we've gone overboard in the
24 ring-fencing, because we are trying to put enough
25 assurances and ring-fencing into this transaction so

1 that Standard and Poors will recognize that and not
2 penalize us too much by trying to keep a limited
3 spread between the holding company rating and the
4 utility debt rating.

5 But Standard and Poors looks -- has a
6 little difference in their approach than Moody's and
7 Fitch do.

8 Q. So, it may or may not have made a
9 difference to Standard and Poors whether their credit
10 watch was before perhaps additional conditions were
11 put on the transaction?

12 A. Their credit watch was the first thing
13 they do. But I don't want you to think that
14 necessarily -- they will consider the entire corporate
15 structure in their evaluation. The ring-fencing is
16 what we're really putting in. We've told them about
17 the, what we consider the regulatory ring-fence which
18 exists in the current Commission.

19 But we're working with Staff to provide
20 more and more assurances and more and more separation
21 and more and more ring-fencing so that Standard and
22 Poors can also be comfortable.

23 Q. Something else you said the other day was
24 that you can't guarantee local offices, I guess that's
25 service offices, if the transaction is not approved.

1 And why is that?

2 A. I will continue to look for efficiencies,
3 so I would never put in writing a guarantee that I'll
4 do this or this. But, secondly, it goes to the point
5 of if we're attractive to this investor, we're
6 attractive to other investors. And other investors,
7 if they are strategic investors -- by that I mean if
8 they are other utilities, let's say -- and certainly
9 there's no discussions with Pinnacle or APS, if I can
10 use them as an example. But if they were to come in,
11 they might have a different opinion on what offices
12 should be maintained, what officers should be
13 maintained. If Sempra came in, they would certainly
14 have a difference of opinion.

15 So I can't just guarantee that all those
16 offices would forever be there, yet these investors
17 have committed that those offices are going to be
18 maintained as long as they are the investors.

19 Q. But any transaction by another utility or
20 another investor group would have to be approved by
21 this Commission, wouldn't it?

22 A. That's correct. I think it would require,
23 if there is a stock, or stock exchange from one
24 utility to another, I believe, yes, it would require
25 this Commission's approval.

1 Q. And getting to the issue of the rate
2 filing, the rate review that you filed recently, if
3 for some reason -- I think I have a file sitting on my
4 desk and a request for a procedural conference which
5 may be scheduled soon.

6 Is it your understanding that -- well, we
7 haven't set procedures. It's my understanding we
8 haven't set procedures of how that review is going to
9 go, but if as a result of that review the Commission
10 wanted to change TEP's rates, that that would
11 require -- is it your understanding that that would
12 require a rate case?

13 A. Well, I certainly -- if the result of the
14 rate check started to say that there would be a
15 reduction in rates, I would feel that I would owe my
16 current investors the obligation to make sure that a
17 full rate case is prosecuted.

18 Q. Okay. The testimony or the evidence is
19 that after the transaction is approved, that TEP's
20 capital structure is going to be 60/40 debt-equity
21 ratio. And I'm slightly confused by some of the
22 testimony about what projections are available or what
23 is confidential or what is known or not known.

24 But do you have projections on if the
25 merger goes through what the capital structure of TEP

1 would look like in three to five years?

2 A. I would project that it would stay in that
3 60/40 range. It might go up to 42, but it would stay
4 in that 60/40 range because it would be our
5 anticipation that current earnings would be dividended
6 while we keep the 40 percent equity. And that's what
7 we've committed to, and not reducing the equity below
8 40 percent.

9 This is a balancing act because as the
10 equity ratio goes up, it puts upper pressure on rates,
11 or prices, also.

12 Q. And in your testimony -- and I don't
13 recall whether, if it was rebuttal or your direct, but
14 you made a statement to the effect that there's
15 adequate cash flow to service the debt that's going to
16 be at the UniSource level.

17 A. It's --

18 Q. And I guess, when you say adequate cash
19 flow, I don't have -- is there anything in the
20 testimony, if it's confidential you can tell me, that
21 shows what cash flow will be needed at the upstream
22 and how much in excess TEP or the other subsidiaries
23 are going to generate? So I can evaluate what you
24 mean by adequate cash flow.

25 A. I think that the investors are prepared to

1 answer that question because they are looking at the
2 amount of dividend that would go up and how that
3 services and sweeps to pay off their debt. And I
4 think honestly it would be better referred to them.

5 Q. Okay. I'm happy to do that.

6 My last question involves acting on behalf
7 of Mohave Valley Elementary School District. And I'm
8 going to show you a letter that they think is in the
9 Docket. I'm not so sure because I can't find a copy
10 of it in the Docket.

11 Their representative, Phil Sauceman, who
12 is the superintendent of schools for the Mohave Valley
13 School District, has indicated to me that -- I think
14 he indicated this at a procedural conference, that the
15 only thing they want to put on the record is this
16 letter. And he's fully aware of the discussion we had
17 the other day about the issue of service territory,
18 but I wanted to ask you about the second paragraph of
19 this letter. And I'm just going to read it into the
20 record.

21 It says: We believe the sale will
22 increase our service and reliability of electric power
23 since it is our understanding that UniSource Energy
24 Corporation currently has no service personnel or
25 equipment to respond to outages or emergency

1 situations.

2 I realize I don't have Mr. Sauceman on the
3 phone right now to ask him exactly what he means by
4 that, but I wanted to ask you, do you have any
5 knowledge of what he might be referring to?

6 A. No, I don't. And I don't know the precise
7 location of 6565 Girard, Mohave Valley, Arizona.

8 As far as the thrust of your question on
9 inadequate, we have no service personnel or equipment,
10 we have service personnel and equipment located in
11 Kingman and Havasu. I don't know if we specifically
12 have a piece of equipment located in Mohave Valley,
13 and I don't know how far that is from our nearest
14 service territory. I can only assure you and this
15 Commission that we are dedicated to improving the
16 reliability on this system. People, I don't think,
17 are giving us a chance to prove -- I think that
18 Nogales has, and I hope that you've seen a complete
19 reversal of the attitude in Nogales. Like I say, we
20 have had no outages on this, on our system in this
21 area this year.

22 Now, I also say that, in all candor, these
23 outages are basically driven by weather, because you
24 have all overhead construction and you get winds and
25 you get lightning. We attempt to -- we have increased

1 the frequency of our patrols and we are doing monthly
2 patrols of these systems to see if we can identify
3 areas. We have reset line reclosers, so if you get an
4 outage, it might be a momentary and the line will
5 automatically reclose. And we have more automatic
6 equipment in place. We have upped the inspection of
7 reclosers to monthly, where Citizens was doing a
8 quarterly. We have replaced fuses with automatic
9 reclosers. We have done an extreme amount up here.

10 And these people that believe that they
11 are going to get a better service from Mohave Electric
12 Co-op I think don't understand that Mohave Electric
13 Co-op is going to bring in electricity over the same
14 LAPA or WAPA line that we are. And that is the line
15 that we have had issues with. We haven't had outages
16 in our system. The outages have mainly come from the
17 WAPA system. And we have responded and helped WAPA
18 when they have had outages on that system.

19 We are committed to maintaining proper
20 service to these customers. I'm sorry that they feel
21 the way they do.

22 ALJ RODDA: That's all the questions I
23 have.

24 Commissioners, do you have any other?

25 COM. MUNDELL: One quick question.

1 What is the status of the Springerville
2 expansion?

3 THE WITNESS: It is ongoing. It is a
4 month ahead of schedule. We're trying to move the
5 operation date up a month and we are presently in
6 discussions with Salt River to commence construction
7 on unit four. I think they are still waiting to
8 determine if Mohave Generating Plant is going to go,
9 be closed.

10 COM. MUNDELL: When you told us about the
11 90 or 91 percent generation from coal, did that
12 include or exclude the expansion?

13 THE WITNESS: That excludes the
14 expansion.

15 COM. MUNDELL: That excludes. So when
16 that comes online, what will the percentage be?

17 THE WITNESS: We will only get a hundred
18 megawatt -- we don't have ownership. We have a
19 contract with that. It might up the coal to
20 slightly -- honestly, I think I'd rather put that over
21 to UES Electric and Gas. Like I say, UES Electric and
22 Gas, it's all purchased. The 90 percent is TEP. I
23 hope that we can sit down and discuss the possibility
24 of moving that contract from TEP and put it at UES
25 Electric and Gas so that I can start to get a

1 foundation, a base, security for those customers.

2 ALJ RODDA: All right. Thank you,
3 Mr. Pignatelli. You may be excused.

4 That was on the assumption that Mr. Heyman
5 didn't want to do redirect right now.

6 MR. HEYMAN: No, thank you.

7 MR. POZEFSKY: Your Honor, I wanted to
8 just ask one question.

9 As far as any questions that we may have
10 in response to the answers given to the Commissioners,
11 I don't intend to ask him now but I would like to be
12 able to know if I can ask him on rebuttal if
13 Mr. Pignatelli becomes a rebuttal witness. In other
14 words, there is an appropriate time to ask those?

15 ALJ RODDA: Is it likely he is going to
16 be back?

17 MR. HEYMAN: You know, I really don't
18 know. It just depends on how the case goes. If there
19 are point -- there's obviously nothing I felt that I
20 needed to redirect right now and so he will be
21 available --

22 ALJ RODDA: He is going to be available,
23 though, right?

24 MR. HEYMAN: Yes.

25 ALJ RODDA: I think that's appropriate.

1 MR. HEYMAN: I don't have a problem with
2 that. I just don't want to commit right now to say
3 that he is going to put on separate rebuttal
4 testimony, you know, some additional. But we can make
5 an accommodation if somebody wants to ask --

6 ALJ RODDA: We will talk offthe the
7 record about when he can be available for that.

8 THE WITNESS: I certainly will make
9 myself available for any questions that Commissioner
10 Mayes might have. She or Commissioner Spitzer have
11 not had the opportunity.

12 ALJ RODDA: Thank you very much. I know
13 Commissioner Mayes will be here -- has indicated she
14 will be here tomorrow. I don't know anything for
15 sure.

16 All right. With that --

17 COM. MUNDELL: So get some rest.

18 THE WITNESS: Thank you. I think I'll
19 have a drink.

20 (The witness was excused.)

21 COM. MUNDELL: Mr. Heyman, did you ever
22 find that document?

23 MR. HEYMAN: I did, but I wonder at what
24 point I lost control of my witness.

25 Yes, I did. It's on that same page seven

1 that we were talking about. It is six entries from
2 the bottom. It says some Bates stamp numbers and then
3 for investor group October 13, 2003, presentation.

4 COM. MUNDELL: Thank you.

5 MR. HEYMAN: You're welcome.

6 ALJ RODDA: All right. Just while we're
7 here and still on the record, unless there are
8 objections -- or are there any objections to the
9 admission of Mundell-1 or the Mohave Valley-1?
10 Hearing none, they are admitted.

11 We are going to take a brief recess, like
12 don't leave the room kind of recess. We are going to
13 move the table that's been set up in the back to the
14 front and get started with the -- Mr. Stuart and the
15 panel.

16 (A recess ensued.)

17 ALJ RODDA: We are back on the record.
18 And would you swear in Mr. Stuart.

19

20 SCOTT H. STUART,

21 MARK LIPSCHULTZ,

22 CHRISTOPHER BEHRENS,

23 WELLFORD TABOR,

24 called as witnesses on behalf of the Applicant, having
25 been first duly sworn by the Certified Court Reporter,

1 were examined and testified as follows:

2

3 ALJ RODDA: Mr. Heyman.

4 MR. HEYMAN: Thank you. Your Honor, we
5 had previously had marked for identification as
6 Exhibit A-5 the rebuttal testimony of Scott H. Stuart
7 filed on behalf of UniSource Energy Corporation May
8 25th, 2004.

9

10 DIRECT EXAMINATION

11

12 Q. (BY MR. HEYMAN) Mr. Stuart, would you
13 please state your name for the record.

14 A. (BY MR. STUART) Scott Stuart.

15 Q. And do you have in front of you the
16 document that has been marked for identification as
17 Exhibit A-5?

18 A. Yes, I do.

19 Q. And was this document prepared at your
20 direction under your supervision?

21 A. Yes, it was.

22 Q. And do you have any changes to make to
23 this document at this time?

24 A. No, I do not.

25 Q. Do you adopt the questions and the answers

1 that are contained in Exhibit A-5 as your rebuttal
2 testimony in this proceeding?

3 A. Yes, I do.

4 Q. Do you have a summary of your rebuttal
5 testimony that you'd care to give at this time?

6 A. Yes, I do.

7 Q. Please go ahead.

8 A. Commissioner Hatch-Miller, Commissioner
9 Mundell, Judge Rodda, thank you very much for allowing
10 us to appear before you today.

11 I'd like to quickly summarize three areas
12 of my direct testimony: Who KKR is; why do we think
13 UniSource is an attractive deal; and a brief overview
14 of the UniSource transaction.

15 First, KKR. KKR is a private equity
16 investment firm founded in 1976. We are patient,
17 long-term investors. Our average hold period is seven
18 to eight years and we have owned some investments
19 between ten and 20. This is in stark contrast to
20 today's public equity markets which are focused on
21 quarter-to-quarter earnings and stock prices.

22 We back great management teams. We do not
23 get involved in the day-to-day management of the
24 companies we invest in. We are a small firm with 45
25 professionals. We currently have a portfolio of over

1 25 companies, so we need to limit our activity
2 strictly to the investment side.

3 Each of our companies stand alone. They
4 have their own board of directors and their own
5 management team. Given our long-term focus, it is
6 imperative that our companies invest for future
7 growth. We always want our companies to be better off
8 when we exit than when we started.

9 By way of example, I'd like to give you an
10 overview of another utility that KKR has invested in,
11 International Transmission Company, or ITC. ITC owns
12 the transmission grid in the eastern half of Michigan.
13 The transmission grid in Michigan, unlike Arizona, is
14 in dire need of additional investment. That is the
15 situation we found when we first invested in ITC.
16 Since our involvement in 2003, the management of ITC
17 has increased capital investment from a budgeted \$8
18 million in 2003, which was before our ownership, to
19 \$80 million this year, a ten-fold increase in the
20 investment.

21 This increased investment has led to the
22 creation of over 481 jobs, the people who put this
23 capital to work. This increased investment will lead
24 to increased reliability and lower power costs for the
25 citizens and customers in eastern Michigan. As we sit

1 here today, all parties connected to ITC are happy.
2 The regulators, the customers, the management,
3 employees, and the shareholders.

4 That's why we philosophically support Jim
5 Pignatelli's operating plans for UniSource and its
6 utilities. As Jim said yesterday, a good utility is
7 one with a focus on customer service and community
8 giving and good relations with its regulators.

9 Finally, our customers, the people we work
10 for at KKR, are primarily state public retirees.
11 States like New York, Michigan, California, Oregon,
12 Washington, Illinois and many others are our
13 customers. These state pensioners look to us to, as
14 fiduciaries to invest large dollars over a long time
15 period.

16 So why UniSource? We are investing in
17 UniSource because of the management team, the
18 business, and the regulatory environment.

19 First, the management team. The
20 management team of UniSource is one of the best in the
21 utility industry. We have met directly with over half
22 of the management teams in the industry and,
23 therefore, we feel we have a good experience base to
24 judge. Since 1994, Jim Pignatelli and his team have
25 dramatically improved the financial condition of

1 UniSource. They have a long history of excellent
2 customer service, witness their J.D. Power ratings.
3 They are active in the community through their
4 charitable givings and they enjoy good relations with
5 the regulators.

6 The business of UniSource is quite
7 attractive. UniSource utilities have low-cost
8 generating costs to meet their customer needs and
9 operate in a very high growth market here in the
10 Tucson area and other rural parts of Arizona.
11 Finally, UniSource operates in a stable and
12 constructive regulatory environment. A number of
13 people have asked, in one form or another, how can you
14 pay a premium to the stock price, let Jim Pignatelli
15 and his management team run the business the same way
16 they have for years and be left with an attractive
17 investment? The simple answer is, UniSource was an
18 undervalued stock in the public market. While we paid
19 a premium to the market price, we paid no premium to
20 the intrinsic value of the company.

21 In KKR's 28-year history, we have taken
22 approximately 30 companies private. That is, we have,
23 just like in this transaction, we have moved their
24 ownership status from public to private. So after
25 looking at hundreds of ideas each year, we on average

1 have found one which will shift from public to private
2 ownership.

3 Why was UniSource undervalued? I think
4 there are a couple of reasons. Number one, today's
5 stock market ignores small cap companies. Research
6 coverage has dried up. Jim Pignatelli mentioned only
7 one research analyst covered UniSource. So investors
8 don't have the time or the information to understand
9 the details of the business. In addition, today's
10 stock market is focused on the short term, usually
11 quarter to quarter if not month to month if not week
12 to week movement in earnings and stock price. As
13 private equity investors, we took the time to
14 thoroughly study the company and we have a long term
15 horizon which allows us to properly value this
16 company.

17 So if you don't remember anything else
18 about my introductory comments, please remember this:
19 All we are doing, the essence of this transaction, is
20 we are taking Jim Pignatelli and the management team's
21 long-term plan, putting our capital structure on top,
22 and that generates an attractive return. There is
23 nothing else to the story, and the reason is the stock
24 price was undervalued.

25 Finally, I would like to turn to a quick

1 overview of the UniSource transaction. When you boil
2 it all down, all we are doing is replacing one set of
3 institutional shareholders for another. As a public
4 company, UniSource was owned 70 percent by
5 institutions. Following this deal, institutions will
6 own over 90 percent with management owning the rest.
7 This transaction brings real benefits to the
8 stakeholders of UniSource. We insure the local
9 presence. The headquarters and local management teams
10 will remain in place. As part of our deal, Jim
11 Pignatelli and his management team will enter into
12 five-year employment agreements. That's something we
13 want, that's something the management team wants, and
14 it sounds like there are many people who support that
15 idea, and that's something that we have committed to
16 each other.

17 As a private company, Jim and his team
18 will not spend time talking to public shareholders.
19 Jim mentions he spends 30 percent of his time doing
20 that today. Instead, he will focus on running the
21 utilities. The charitable giving programs will also
22 be continued. The financial condition of the utility
23 will be strengthened. The investor group is investing
24 over one quarter of a billion dollars in Tucson
25 Electric Power. This improves the debt-equity ratio

1 from twenty -- sorry, from 25 to 40 percent, a
2 five-year acceleration of that event. The utility
3 will be in much better shape to handle unforeseen
4 contingencies, outages, price spikes, whatever could
5 happen.

6 This equity infusion and our involvement
7 has already, in part, has already resulted in TEP
8 achieving better terms on its recent refinancing. The
9 interest rate has moved from 6.5 percent to under four
10 percent, and as importantly, the maturity has moved
11 from one year to five years.

12 UniSource has committed to spend \$1.5
13 billion in O&M and capital over the next four years.
14 The company has also committed to reduce debt by \$400
15 million over the same time period. The company is
16 committed to over 40 conditions which will strengthen
17 and protect the utilities.

18 In essence, the company has shifted risk
19 from the customers to the investors, and the company
20 has agreed to numerous conditions which prevent that
21 risk from coming back to the customers. Said another
22 way, the company is converting the plans and
23 projections at TEP into legal commitments.

24 So, Commissioners, we like Arizona, we
25 like UniSource, we want to invest in Arizona and we

1 want to invest in UniSource. And with your approval,
2 we would like to bring capital to UniSource to support
3 the growth plans of utilities in Tucson and rural
4 Arizona.

5 MR. HEYMAN: Thank you, Mr. Stuart.

6 With that, I would like move for the
7 admission of Exhibit A-5.

8 ALJ RODDA: Any objections to A-5? Then
9 we will admit it.

10 MR. HEYMAN: At this time, Judge Rodda,
11 what I would also like to do is reintroduce
12 Mr. Lipschultz, Mr. Behrens and Mr. Tabor. Since they
13 have already been sworn in, I'd just ask them to
14 briefly introduce themselves, who they represent and a
15 little bit of background.

16 We would start with Mr. Lipschultz.

17 MR. LIPSCHULTZ: My name is Marc
18 Lipschultz. I'm a member of KKR. I focus primarily
19 in the energy sector and am one of the investors that
20 seek investments in this sector.

21 MR. BEHRENS: Christopher Behrens. I'm a
22 partner with J.P. Morgan Partners. We are a
23 wholly-owned subsidiary of J.P. Morgan Chase. We are
24 managing a six and a half billion dollar fund, of
25 which 70 percent of those come from J.P. Morgan Chase.

1 The other 30 percent come from state pension funds,
2 other institutional investors, high net worth
3 employees and individuals. I focus primarily on power
4 energy investments and I have been there over nine
5 years.

6 MR. TABOR: My name is Wellford Tabor. I
7 am a partner with Wachovia Capital Partners in
8 Charlotte, North Carolina. Our group, over the last
9 15 years, has invested \$13 billion on behalf of the
10 corporation as well as the firm. So the dollars we
11 invest are Wachovia deposits and personal monies that
12 me and the other nine partners put up in every
13 transaction. My primary responsibility at the firm is
14 for the power energy investments we make.

15 ALJ RODDA: Thank you.

16 MR. HEYMAN: Your Honor, these men have
17 been involved in the negotiations of the transaction
18 and we have offered them as a panel. I would now
19 tender them for cross-examination by the parties and
20 the Commissioners.

21 ALJ RODDA: Thank you, Mr. Heyman.

22 What I'm going to do is I'm going to start
23 with some of the Intervenors who have indicated more
24 limited cross-examination than others. And so I'll
25 ask Mr. Enoch, do you have some questions for

1 Mr. Stuart or this panel?

2 MR. ENOCH: Yes, I do, Your Honor.

3 Good afternoon, Your Honor, Commissioners
4 Mundell, Hatch-miller. Thank you very much for
5 fitting us in at this late hour. I will try to do it
6 as quickly as possible.

7

8 CROSS-EXAMINATION

9

10 Q. (BY MR. ENOCH) In case you missed it, my
11 name is Nicholas Enoch. I'm the attorney who
12 represents Locals 387 and 769 of the International
13 Brotherhood of Electrical Workers. Frankly, I've
14 never questioned a panel before, and going first, I
15 guess I get to kind of decide how I'd like to do it.

16 As you can probably assume, my questions
17 are going to be dealing with my constituency, which is
18 the unions and the employees. So is there a person I
19 should direct these questions to?

20 A. (BY MR. STUART) Why don't I start and
21 then I'll hand it off if appropriate.

22 Q. That's fine. The only experience I've
23 seen was when the executives at the tobacco companies
24 were testifying that nicotine is not addictive. But I
25 don't anticipate going down the that line.

1 But I will tell you in advance, at the
2 conclusion of my questions, I will probably ask each
3 of you to point out if you have any disagreement with
4 one of the answers by Mr. Stuart. So if there is
5 something, if you'd like to interject, that's fine.
6 But bear in mind that question will be coming at the
7 end.

8 What is the investors' understanding of
9 the nature of the relationship between UniSource and
10 the three locals of the IBEW that represent the
11 employees of the company?

12 A. You mean the relationship between --

13 Q. Currently.

14 A. -- management and the constituents you
15 represent?

16 Q. Correct.

17 A. I understand -- first of all, once again,
18 we are investors. We are not operators. So union
19 relations is something that is squarely in the purview
20 of Jim Pignatelli.

21 What Jim and his colleagues has told us is
22 that he enjoys a good relationship with you and your
23 constituents. And that's all he's really had to say.

24 Q. Well, to the extent that you're not
25 concerned, I don't want to put words in your mouth, if

1 the feedback would have been that the relations
2 weren't so good, would that certainly have been a
3 negative consideration in moving forward?

4 A. Yes.

5 Q. Assuming arguendo the Commission approves
6 this merger, do the investors agree with the notion
7 that a deterioration in the future of the relationship
8 between the company and the three IBEW locals would
9 have a negative impact on the company's ability to
10 provide safe, reasonable, and adequate service to the
11 patrons of the company?

12 A. What I would say is, once again, this is
13 really Jim and his team's purview. We have no
14 involvement in this matter. However, enjoying good
15 relations with labor unions I think is a positive
16 thing.

17 Q. So, to the extent that there is a positive
18 relationship now, you would not -- let me rephrase
19 that.

20 To the extent there is a positive
21 relationship now, you would agree if years from now or
22 months from now for whatever reason things turn south,
23 that would not be a positive development, correct?

24 A. That's right.

25 Q. Assuming arguendo that the Commission

1 approves this merger, would the investors agree with
2 the notion that, again, a deterioration in the
3 relationship between the three IBEW locals and the
4 company, that that situation would have a negative
5 impact on the ability of the company to attract
6 capital at fair and reasonable terms?

7 A. You know, I'm not familiar with this term,
8 arguendo. I'm not a lawyer.

9 Q. I'm assuming that the Commission will
10 approve the application.

11 A. I like that phrase.

12 COM. HATCH-MILLER: For the purposes of
13 the questions.

14 Q. (BY MR. ENOCH) And we are at some point
15 in the future --

16 A. I'm sorry. I just wasn't familiar with
17 the phrase.

18 Q. And further assume for purposes of my
19 question that there is actually a deterioration for
20 whatever reason in the relationship between the three
21 locals and the company.

22 Would you agree that that would have a
23 negative impact on the ability of the company to
24 attract capital at fair and reasonable terms?

25 A. I can't, I'm speculating, but I can say

1 that -- you're asking me to comment on how all the
2 capital providers that are out there would respond to
3 an issue of labor relations, and my honest answer is I
4 don't know. It would depend on how bad the situation
5 was, is probably the fair answer.

6 Q. Well, have you ever seen a negative
7 relationship or a deteriorating relationship between a
8 company and its certified bargaining, certified
9 representative of its employees have that sort of
10 negative impact on the ability of a company to attract
11 capital at fair and reasonable terms?

12 A. I've never had -- I can't think of a
13 direct experience.

14 Q. It's possible?

15 A. It's certainly possible.

16 Q. Do any of the other investors have an
17 opinion on that subject?

18 A. (BY MR. LIPSCHULTZ) No different opinion.

19 A. (BY MR. BEHRENS) No.

20 A. (BY MR. TABOR) I agree with what he said.

21 Q. Mr. Pignatelli testified earlier today
22 that the collective bargaining agreements in effect
23 will continue. That's your understanding as well,
24 correct?

25 A. (BY MR. STUART) Yes.

1 Q. And he either said it or I took it
2 implicitly that he expected that the relationship
3 between the company and the unions would remain
4 excellent. Is that also your understanding?

5 A. Yes.

6 Q. The On May 24th, Commissioner Mayes sent a
7 letter to the Docket in which she asked a long list of
8 questions, but I'm going to pinpoint two of them in
9 particular.

10 On the second page of the May 24th letter,
11 she asked the following: I would like to know whether
12 the investors intend to outsource any of the company's
13 current operations.

14 A. I would answer that question a couple
15 ways. First of all, the whole concept that the
16 investors would outsource is not at all what this is
17 about. We are investors. Jim and his team are
18 managing the company. So it's a, you know -- I can't
19 even -- there is not really even a basis for me to
20 answer that question. I would say that whatever Jim
21 Pignatelli would like to do is what's going to happen
22 since he is running the business.

23 I think I recollect, though, him
24 testifying today or yesterday that he didn't have any
25 plans to outsource. So --

1 Q. And you wouldn't --

2 A. He speaks for us on matters like this.

3 Q. Okay. And, similarly, Commissioner Mayes
4 asked: I would like to know whether there would be
5 any post-merger changes in employee benefits.

6 Would your answer be the same to that?

7 A. Same answer.

8 Q. On page ten of the notice of intent, which
9 is dated December 29th, 2003, in section three,
10 subsection three, it says the following: The local
11 operations of TEP, UNS Gas and UNS Electric, including
12 employee and labor relations, shall be under the
13 supervision of local management.

14 Can you describe for me more strategic
15 decisions? I don't know if -- I can read this two
16 ways, which is, you know, setting hours of work and
17 what time you go to lunch and all of that. That would
18 be decided locally. But how about strategic decisions
19 such as who has final say over collective bargaining
20 agreements for purposes of the company? Who would
21 actually make that decision?

22 A. Management.

23 Q. Who is management?

24 A. Jim Pignatelli and his management team.

25 Q. Is that your understanding that would be

1 run past the investors?

2 A. No. Absolutely not.

3 Q. Would the investors be providing any input
4 or instructions with respect to issues like that?

5 A. No.

6 Q. On the same document, which is actually on
7 page two now, there is a footnote, footnote one.

8 Pardon me for being suspicious, but --

9 A. Should I be reviewing something?

10 Q. I would be happy to show it to you. But
11 at the beginning -- let me read it first.

12 The first line at the top is benefits of
13 the merger, and it says UniSource Energy believes that
14 the merger will produce, dot-dot-dot. And then there
15 is a footnote under, after UniSource Energy which
16 takes you down below and it says UniSource Energy
17 Corporation and its utility affiliates shall sometimes
18 be collectively referred to as UniSource Energy for
19 purposes of the remainder of the document.

20 Okay? You can take a look. Do you see
21 how it's been defined?

22 A. Yes.

23 Q. Now, when -- I was reading the last
24 section, which is on page ten. On this page, they
25 actually kind of go back and forth between UniSource

1 Energy, TEP, UNS Gas, UNS Electric. And let me tell
2 you how, exactly the paragraph that I read.

3 It says the local operations of TEP, UNS
4 Gas and UNS Electric, including employee and labor
5 relations, shall be under the supervision of local
6 management. It doesn't use that term UniSource
7 Energy.

8 Is there any significance to that or am I
9 just paranoid?

10 A. I won't comment on your mental state, but
11 I, I think there's nothing to worry about. And if
12 you'd like, I assume we could clear up the language.
13 This is not my document.

14 Q. It would be fair to assume that means
15 UniSource Energy?

16 MR. HEYMAN: Right. We are talking about
17 small paren three -- is that correct -- on the merger
18 agreement stipulated conditions. I believe that's the
19 same -- so everybody can see the language that we are
20 talking about.

21 MR. ENOCH: Okay.

22 MR. HEYMAN: We certainly can clean up
23 any language.

24 Q. (BY MR. ENOCH) So for our purposes,
25 though, we can assume UNS Gas and UNS Electric is

1 synonymous with UniSource Energy as defined in the
2 document?

3 A. And TEP, rightthe? The definition
4 includes all three?

5 Q. Correct. The definition actually says
6 UniSource Energy and its utility affiliates shall
7 sometimes be, shall sometimes be collectively referred
8 to as UniSource Energy.

9 A. Right. That's everything, everybody.

10 Q. So, to the extent that condition three
11 says the local operations of TEP, UNS Gas and UNS
12 Electric, that could simply read UniSource Energy.

13 A. That's fine with me. It's not my
14 document, but --

15 Q. The -- you had indicated, Mr. Stuart, that
16 KKR is, to a large degree, owned by pension funds.
17 Correct?

18 A. Well, the firm is owned by the partners of
19 the firm. We then raise funds and those funds come
20 from primarily large state pension funds.

21 Q. You administer the funds of --

22 A. We invest capital on behalf of retirees.

23 Q. And I believe you also testified that at
24 least a large portion of that is of public employees
25 from eastern states, correct?

1 A. Actually, no. It's larger, western
2 states, but it's states all over the country.

3 Q. And if you know, is it fair to assume that
4 a lot of those pension funds come from unionized
5 public sector employees?

6 A. Yes.

7 Q. And, in fact, do these pension funds, if
8 you know, do they have any union trustees on the
9 pension funds?

10 A. Yes. Many of them do.

11 Q. And in your experience, have any of these
12 trustees of the pension funds -- and I mean the -- we
13 will call them union representatives on the pension
14 funds. Have they ever made any complaints to KKR
15 regarding the management of any of the companies that
16 you're invested in?

17 A. Yes.

18 Q. And can you describe for me the nature of
19 those complaints.

20 A. The nature of the complaint usually is the
21 CEO of a company is doing something that the union
22 employees don't like, and the union employees come to
23 us and say please make them stop. And we say, which
24 we are saying to you, is we are investors. We don't
25 get involved in matters like that. So that's the

1 dialogue that's happened in a couple of cases.

2 Q. Have you ever relayed those sorts of
3 concerns back on to the management of the company?

4 A. Yes. Absolutely.

5 MR. ENOCH: That's all. Thank you very
6 much.

7 ALJ RODDA: Thank you, Mr. Enoch.

8 Mr. Meek, do you have some questions for
9 Mr. Stuart?

10 MR. MEEK: Thank you, Your Honor, members
11 of the Commission.

12

13

CROSS-EXAMINATION

14

15 Q. (BY MR. MEEK) Mr. Stuart, Mr. Lipschultz,
16 Mr. Behrens and Mr. Tabor, good evening. Let's get
17 out of here.

18 My ground rules are that I'm going to ask
19 my questions of Mr. Stuart, but any time any of the
20 rest of you want to chime in for some reason or other,
21 please feel free to do so. And occasionally, I might
22 ask you to nod in unison if it's appropriate.

23 And on that note, just for the record, it
24 is clear that this is not the new management team?

25 A. The (BY MR. STUART) The four of us?

1 Q. Yes.

2 A. This is not the new management team.

3 Q. Mr. Stuart, in your rebuttal testimony, on
4 page three as a matter of fact, you listed four
5 reasons for investing in UniSource. And you covered
6 this to some degree but let me just go through these
7 four reasons with you, at least one at a time.

8 And the first one was the existence of a
9 sound management team. Now, I was going to ask you
10 what is so good about these guys but I think you've
11 already answered that question and instead I'll simply
12 ask this: Would this be a questionable investment if
13 this management team were not in place?

14 A. If, if there were not a very, very good
15 management team in place -- and certainly Jim is. If
16 there were not a good management team in place, we
17 would not be making this investment.

18 Q. And I assume, therefore, that you're in
19 support of Mr. Pignatelli's efforts to try to keep
20 this team together, correct?

21 A. Absolutely.

22 Q. Your second reason was lower cost coal
23 generation. And let me ask you this: Was that in
24 comparison, for example, with the trend toward gas
25 generation today?

1 A. That's one way to look at it, yeah. I
2 mean, there are different types of generation. And
3 when you look at a region, it's important to know
4 who's got low-cost generation because that tends to
5 make customers happiest. And the fact that they do
6 have lower cost, less volatile coal-fired assets is a
7 very good thing.

8 Q. Let me ask you this. This doesn't apply,
9 does it, that you have a slavish devotion to coal as
10 opposed to other possibilities like renewables and
11 distribution of generation and --

12 A. That's right.

13 Q. Okay. Rate stability. What did you mean
14 by rate stability?

15 A. Marc, Mr. Lipschultz, would you like to
16 handle that?

17 A. (BY MR. LIPSCHULTZ) Sure.

18 I think by rate stability what we meant is
19 really two things. One is a constructive history
20 between the Commission and the company in terms of
21 rate filings, and those be rational, well thought out,
22 well adjudicated cases yielding rational results.

23 I think second specifically in this case
24 is the rate freeze that's in place subject to this
25 2004 rate check and the stability that that presents

1 in terms of rates.

2 Q. So, in that sense, you're referring
3 specifically to the time period between now and 2008?

4 A. Correct.

5 Q. You're not suggesting rates will never go
6 up.

7 A. No. I'm not suggesting I know what will
8 happen in 2008. That's clearly management's purview
9 and this Commission's purview. No, we are referring
10 to through 2007 or 2008 when you are talking about the
11 UES companies or TEP.

12 Q. The fourth reason was growth potential.
13 And just by way of background, in a state which is
14 always constantly either first and second in the
15 country in terms of growth rate, growth is sort of a
16 two-edged sword. We know that growth brings new
17 customers. On the other hand, growth also requires
18 utilities, for example, to continuously invest money
19 in infrastructure.

20 Would you give me your take on what the
21 upside is on growth?

22 A. (BY MR. STUART) Sure. You know, by
23 contrast, I would say there are a lot of utilities
24 where the growth rates are quite low, and the
25 opportunity for investors to earn a decent return are

1 tougher in those situations. When you have growth
2 areas, then you have the opportunity to grow those
3 businesses by investing more capital. And to the
4 extent there is a stable regulatory environment that
5 allows capital to earn fair returns, then that
6 situation leads to increased shareholder value over a
7 very long period of time.

8 Q. Okay. So the it is the increase in
9 shareholder value that intrigues you the most in terms
10 of the growth environment?

11 A. I would say as an investor, that's true.
12 I would also say, though, growth and the economic
13 vitality that that brings in an area just makes it a
14 good place to do business. Not just as a utility, but
15 a homebuilder, a lot of businesses that exist in
16 growth areas. It's always easier to sail with wind at
17 your back.

18 Q. Having gone through those, let me ask you
19 a couple of what may be sort of the \$64,000 questions
20 in this proceeding.

21 How are you going to make money in this
22 transaction?

23 A. As I mentioned in my opening remarks, if
24 you take the management's plans and you put our
25 capital structure on top of it and you just assume

1 that Jim Pignatelli and his team continue to do in the
2 future what they have done in the past, we will pay
3 down debt over time. We are not anticipating taking
4 out any current dividends to the shareholder group,
5 and we will make money by exiting this investment at
6 some point far into the future through a combination
7 of getting a good price for the asset and having
8 de-leveraged the company over time.

9 Q. So it is the overall value that you're
10 looking to improve as time goes by.

11 A. That's right. It's not dissimilar from
12 buying a house, which you might own for a long period
13 of time. And when that house needs repairs, when the
14 roof breaks, you fix it, and you cut the grass and you
15 make sure it looks very, very good so 20 years later,
16 when you've paid off your mortgage, not only is it
17 debt-free but the asset value is at its highest
18 because it's viewed to be a well-maintained place.

19 Q. And it is not your interest to extract
20 cash as you go along as much as you can?

21 A. That's not anticipated, no. To extract as
22 much cash along the way could have a detrimental
23 impact on the value of the asset.

24 Q. And you led into the second question, and
25 that is, do you have or can you conceive of an exit

1 strategy?

2 A. Well, we never know what our exit strategy
3 is going to be, or the timing, when we go into deals.
4 But in the history of our firms, there have been two
5 ways we have exited the investments. One is to take
6 the companies public again. We have talked about how
7 that, how that's quite difficult in today's market,
8 but it's not impossible. And the second way is to
9 merge with another company.

10 So I think those are the two theoretical
11 ways for us to do it.

12 Q. Well, you're looking at an investment
13 horizon that is at least probably seven or eight
14 years, and perhaps longer, and clearly conditions for
15 going public could change between now and then.

16 A. Absolutely. The markets are very fickle.

17 Q. Let me turn for a second to section 6.06
18 in the agreement, which has been mentioned. I am not
19 sure it's in your testimony or not.

20 MR. HEYMAN: Can I just mention that's on
21 the first board up there? It might be easier for
22 people to refer to that than flipping through
23 documents.

24 THE WITNESS: Okay.

25 ALJ RODDA: If you have your glasses,

1 yes.

2 MR. HEYMAN: Maybe it would be easier to
3 look through documents.

4 Q. (BY MR. MEEK) That's right. That is the
5 first board. I didn't realize that.

6 I'm not going to go through all of these,
7 but I want to touch on two or three. And you'll note
8 that number one is that the corporate headquarters
9 shall remain in Tucson, basically.

10 A. Right.

11 Q. And I simply wanted to point out or have
12 you confirm that that requirement was in this
13 agreement from the beginning.

14 A. Absolutely. That was always very
15 important to Jim Pignatelli and to us.

16 Q. And number three, which has already been
17 discussed, actually, that the local operations of TEP,
18 UNS Gas and Electric would all remain under the
19 supervision of local management. Frankly, to me, that
20 sounds sort of like a totalitarian, or at least a
21 self-executing statement. What is that really meant
22 to mean?

23 A. What I took that to mean is that
24 management -- number three. I view all that to fall
25 under the heading of Jim Pignatelli and his team are

1 going to run the business, and the existing management
2 teams that are there, as Jim has told me, will
3 continue to manage the company, including employee and
4 labor relations.

5 Q. Okay. So that basically refers to the
6 entirety of the UniSource operation.

7 A. Right.

8 A. (BY MR. TABOR) You could take the word
9 local out in both places. The operations will be run
10 by the management. I think that's what we meant.

11 Q. I have to confess it was the local that
12 sort of confused me.

13 Let me move down to number six, which
14 essentially says that TEP, UNS Gas and UNS Electric
15 will be managed to accommodate the service territory
16 growth, including appropriate expansion of the asset
17 base. Appropriate expansion of the asset base. Can
18 you elaborate on that for me a little bit?

19 A. (BY MR. STUART) Sure. As territories
20 grow, new housing developments are put in place,
21 distribution wires need to be built. There's talk,
22 obviously, of expanding the transmission in this area.
23 As I mentioned before, at ITC, we know a lot about
24 investing in companies that grow their transmission.
25 Jim has talked about the need down the road for

1 additional generating assets. The business is growing
2 and it needs a bigger asset base in order to meet the
3 needs of its customers. So that's how the asset base
4 needs to grow.

5 Q. And number seven then talks about
6 investing adequate capital to provide safe, reliable
7 and adequate service to the customers of TEP, UNS Gas
8 and UNS Electric.

9 I don't see a significant distinction
10 between six and seven. Is there a shade of difference
11 there that I'm missing?

12 A. I can't find one, either. I don't know if
13 any of my colleagues can, but --

14 Q. Okay. Now, with regard to both of those,
15 six and seven, there's been a lot of discussion in
16 this proceeding until now about the agreement to
17 invest or spend roughly a billion and a half dollars
18 over the next several years.

19 Let me ask if I can, these two
20 requirements, could they in fact exceed the 1.5
21 billion commitment if the capital is required?

22 A. I'm sorry. Could you repeat the question?

23 Q. Could these requirements as they are laid
24 out here, to expand the asset base and to invest in
25 customer service, could those requirements bring the

1 agreement outside the 1.5 billion dollars if
2 necessary?

3 A. Could more than 1.5 billion be spent --

4 Q. Yes.

5 A. -- over a four-year period?

6 Q. Thank you very much.

7 A. Theoretically, that's true, although the
8 plans we have seen from the management do not
9 demonstrate that.

10 Q. Okay. But they could.

11 A. If --

12 Q. These requirements are not tied
13 necessarily directly to a billion and a half dollars.

14 A. That's right.

15 A. (BY MR. LIPSCHULTz) Excuse me, but I
16 think the plans are tied to the billion and a half
17 dollars. But if the question is is it possible could
18 it be different --

19 Q. What I really meant was these agreements.
20 I won't call them conditions. Maybe they are. But
21 these agreements seem broader than any dollar figure
22 and I was trying to confirm if that's the case.

23 A. (BY MR. BEHRENS) The condition is minimum
24 O&M expense and capital commitments. So, presumably,
25 six and seven could create more expenditure than the

1 minimum amount.

2 Q. That's what I was getting at.

3 A. (BY MR. TABOR) Yes.

4 Q. Mr. Stuart, this is a test. What is the
5 first and foremost duty of a public utility?

6 A. I don't have a professional answer, but
7 I'll tell you to serve the public interest, deliver
8 reasonably priced power, good reliability, take care
9 of your customers, be a presence in the local
10 community, support community charitable efforts.

11 Q. So from your point of view as an investor,
12 the first duty of a utility, nevertheless, is to serve
13 customers?

14 A. Yes.

15 Q. I got one last thing. You were in the
16 room, I believe, yesterday when I discussed with
17 Mr. Pignatelli Commissioner Mundell's letter of June
18 10th that raised the query about whether or not it
19 would be appropriate to delay these proceedings, or
20 the decision in this case until a rate inquiry was
21 completed by the Commission. Did you hear that?

22 A. Yes.

23 Q. I'm not going to take you back through all
24 that. I believe you're familiar with the document
25 that I handed to Mr. Pignatelli, which was our data

1 response to his letter.

2 I'm simply going to ask you this: What is
3 the tolerance of the investors for a delay in this
4 proceeding in order to investigate the company's rate
5 situation?

6 A. I'd answer that question a few ways. And
7 Commissioner Mundell mentioned that we actually had
8 thought about tying the rate check to approval of our
9 transaction. However, in the matter of regulatory
10 proceedings, we defer 100 percent to Jim Pignatelli
11 and the management team. That's very much a part of
12 the management's purview in a utility. And we were
13 advised that that was not the way to go. So we have
14 accepted that and we are moving forward with the
15 process the management team has outlined.

16 I would say that to the extent that a
17 process was, to the extent this process was
18 interrupted over some sort of investigation around
19 rates, there is a serious risk that the capital
20 markets would have a negative reaction to that. There
21 are people in this room who represent equity,
22 represent hedge funds who are here to see how these
23 hearings are going and holding their finger up and
24 trying to determine if they should buy stock tomorrow
25 and sell it the next day. We have to raise

1 subordinated debt in order to complete this
2 transaction, and to the extent the markets get
3 spooked, that condition may not be met and this deal
4 may not happen.

5 So I think I would raise a high level of
6 caution about how this issue gets dealt with.

7 MR. MEEK: Thank you, Your Honor. That's
8 all I have.

9 ALJ RODDA: Thank you, Mr. Meek.

10 Mr. Magruder, let me ask you, how long do
11 you think your questions will take? I think
12 Mr. Pozefsky has extensive questions but --

13 MR. POZEFSKY: I do.

14 ALJ RODDA: Would it be more efficient to
15 hear Mr. Pozefsky's questions so there wouldn't be
16 duplication?

17 MR. POZEFSKY: That's what we were
18 talking about.

19 ALJ RODDA: Okay. Then I think that,
20 unless someone objects, that we should call it a night
21 here and pick up again tomorrow at 9:00, unless there
22 is another Intervenor who has only a few questions.

23 Then we will start-up in the morning. We
24 will start with Mr. Pozefsky at 9:00 a.m.

25 And, witnesses, you've got to sit in that

1 same order, okay? Because I've written your names
2 down.

3 MR. HEYMAN: Your Honor, assuming that we
4 are through with the panel tomorrow, is it still the
5 plan to call Mr. Antonuk as a witness? We had a set
6 date for him of Wednesday.

7 ALJ RODDA: Yes. We will then go out of
8 order and go to Mr. Antonuk because he has to, he
9 has --

10 MR. POZEFSKY: I'm just trying to get an
11 idea because Ms. Diaz Cortez is also in a situation
12 where her time is critical as far as we anticipated,
13 as you recall, Tuesday afternoon. Now that we don't
14 have it, she has a couple negotiations going on in the
15 Southwest Gas case.

16 ALJ RODDA: Let's have this discussion
17 offthe the record. Is that okay?

18 MR. POZEFSKY: Yes.

19 (Proceedings recessed at 5:55 p.m.)

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1 STATE OF ARIZONA)
) ss.
2 COUNTY OF MARICOPA)
3

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12 2004.

13 *Dawna J. Boswell*

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