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BEFORE THE ARIZONA CORPORATION C

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Arizona Corporation Commission
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JIM IRVIN
Commissioner - Chairman
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IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY.	DOCKET NO. E-01933A-98-0471
IN THE MATTER OF THE FILING OF TUCSON ELECTRIC POWER COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1602 et seq.	DOCKET NO. E-01933A-97-0772
IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY	DOCKET NO. E-01345A-98-0473
IN THE MATTER OF THE FILING OF ARIZONA PUBLIC SERVICE COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1601 et seq.	DOCKET NO. E-01345A-97-0773
IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. RE-00000C-94-165 **NOTICE OF FILING**

Pursuant to the Procedural Order dated November 13, 1998, Tucson Electric Power Company hereby files the Direct Testimony of James S. Pignatelli, Dean E. Criddle and John G. Paton.

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RESPECTFULLY SUBMITTED this 20th day of November, 1998

TUCSON ELECTRIC POWER COMPANY

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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
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IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY.	DOCKET NO. E-01933A-98-0471
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IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. RE-00000C-94-165 **DIRECT TESTIMONY OF JAMES S. PIGNATELLI**

On Behalf of
TUCSON ELECTRIC POWER COMPANY

NOVEMBER 20, 1998

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. James S. Pignatelli, 220 West Sixth Street, Tucson, Arizona 85702.

Q. WHAT IS YOUR POSITION WITH TUCSON ELECTRIC POWER COMPANY ("COMPANY" OR "TEP")?

A. I am Chairman of the Board, President and Chief Executive Officer. I also hold these same positions with TEP's parent company, UniSource Energy Corporation.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The primary purpose of my testimony is to provide a general overview and policy perspective with respect to the Settlement Agreement dated November 4, 1998 ("Agreement") that was entered into between TEP and the Arizona Corporation Commission ("Commission") Staff.

Q. IN GENERAL, WHY DO YOU SUPPORT THIS SETTLEMENT PROCESS?

A. First, let me say from the outset that even before the adoption of the Commission's Retail Electric Competition Rules ("Competition Rules") on December 26, 1996, TEP has been an avid supporter of competition in the retail electric industry. In anticipation of competition, TEP formed its holding company, expanded into other competitive energy businesses and reduced its costs. These cost reductions resulted in present and future rate decreases for its customers. The Company has been devoting significant resources to meet the January 1, 1999 start date for competition that the Commission established with the support of many of the parties to this proceeding. In order for competition to become a reality in Arizona by that date, certain crucial issues must be resolved. I believe that this Agreement, and the process under which it is being considered, is the only way to resolve those issues in time and get competitive access underway for Arizona consumers.

Q. WHAT IS THE BASIS OF THE AGREEMENT?

A. Pursuant to Commission Decision No. 60977 dated June 22, 1998 ("Decision") and A.A.C. R14-2-1607, Affected Utilities (such as TEP) were required to make a stranded cost filing with the Commission by August 21, 1998. Additionally, Affected Utilities were required to choose between two options for stranded cost. The first option, "the Divestiture Option," permitted an opportunity for an Affected Utility to recover 100 percent if it divested itself of its generation assets. The second option, the "Transition Revenue Option," provided an Affected Utility less than 100 percent recovery as it would only receive transition revenues

for a period of time to permit the Affected Utility to maintain financial viability. As TEP has demonstrated throughout the electric competition proceedings, the opportunity for 100 percent stranded cost recovery is essential to the Company's financial future. The "auction and divestiture" option provides Affected Utilities this opportunity. As a result, on August 21, 1998, TEP filed its plan for stranded cost recovery ("Plan") which requested Commission authorization for the Company to auction off it generation assets as a market based solution to determine TEP's stranded costs. The Plan also requested authorization for TEP to privately securitize its stranded cost recovery in order to provide the funds necessary to pay the debt associated with the assets to be divested, and to lower costs to customers.

Consistent with the Decision, which already provides TEP with an opportunity to recover 100 percent of its stranded costs if it elects divestiture, the Agreement is an extension of this Decision by providing the methodology for such recovery. The Company and Staff believe that a settlement of the stranded cost issues is preferable to a lengthy and contentious hearing process. As a result, TEP and the Staff entered into settlement discussions. Concurrently, the Company entered into discussions with Arizona Public Service Company ("APS") with respect to the "Transco" proposal (discussed below) which TEP views as an integral part of the Agreement.

Q. PLEASE OUTLINE THE MAJOR PROVISIONS OF THE AGREEMENT.

A. To complete the divestiture of TEP's generating assets in a way that will allow the Company to fully recover stranded costs, while providing the benefits of competition to its customers, the Agreement provides, among other things, the following:

a. Approval of the Company's proposed auction process, including associated documentation and bidding protocols;

b. Approval of the transaction set forth in the Memorandum of Understanding dated November 4, 1998 between the Company and APS regarding Transco (see discussion below);

c. An interim mechanism for recovery of stranded costs relating to the period between the implementation of retail electric competition and completion of divestiture;

d. A definitive mechanism for calculation and approval of stranded costs based on the market value of the Company's generating assets, as determined by divestiture of the assets, including approval of the costs associated with such divestiture; and

e. A definitive mechanism for full recovery of stranded costs determined through divestiture, supported by authorization for securitization of the revenue stream associated with stranded cost recovery, and an alternative mechanism for full recovery in the event the Company is unable to successfully divest.

Q. WITH RESPECT TO THE AUCTION PROCESS, HOW LONG DO YOU ANTICIPATE IT WILL TAKE BEFORE THE GENERATION ASSETS ARE SOLD?

A. John Paton of New Harbor, Inc. discusses this in greater detail in his testimony, but once TEP receives a non-appealable order from the Commission, the auction process will be initiated. We anticipate the auction will be completed by the third quarter of 1999. Thereafter, we anticipate completing the transaction after receiving all necessary approvals prior to December 31, 2000.

Q. WHAT WOULD HAPPEN IN THE EVENT OF A FAILED AUCTION?

A. The Agreement has a built in mechanism to provide the Commission flexibility to declare a failed auction in the event that the auction process does not produce satisfactory bids. The "failed auction" scenario is designed to protect customers from having to pay too much for stranded costs, while at the same time providing a fall-back method of stranded cost recovery acceptable to both the Company and Staff. In the event of a failed auction, the Commission would allow the Company stranded cost recovery through a "Net Lost Revenues" approach. That methodology essentially estimates the difference between market revenues produced by the assets and the embedded costs of operating the assets under cost-of-service ratemaking. This is a recognized and acceptable administrative method of calculating stranded costs that was advocated by TEP at the stranded cost hearings held earlier this year.

Q. WHY HAS TEP REQUESTED AUTHORIZATION FOR SECURITIZATION OF ITS STRANDED COSTS?

A. Dean Criddle discusses this in greater detail in his testimony, however, the principal reasons for securitization are to provide the required funds necessary to pay debt associated with the

assets to be divested; and to provide a lower cost means of financing the revenue stream associated with stranded cost recovery.

Q. PLEASE EXPLAIN THE TRANSCO PORTION OF THE AGREEMENT.

A. The Transco proposal permits TEP to exchange with APS, TEP's interests in the Navajo and Four Corners generating plants for certain of APS's transmission assets. Two principal objectives of this transaction are to address vertical market power concerns and achieve competition. After divestiture, TEP's Transco will not own any generating assets and will operate the transmission company separately from its distribution company. Additionally, APS will continue to own generation but will not own or control transmission assets. Customers will benefit through pricing reforms and simplified access through an Independent System Operator ("ISO"). A key feature of the transaction is that transmission rates will not be increased for customers in the current service territories of TEP and APS. Moreover, Transco will provide a rapid jumpstart to the development of an ISO in the Southwest. While genuine efforts are being made through the Desert Star process, I believe that the centralization of ownership of transmission assets will significantly increase the pace of ISO development. I would note that the Agreement contemplates an ISO would be in place by December 31, 2000.

Q. PLEASE DISCUSS TEP'S UNBUNDLED RATES.

A. TEP's unbundled distribution rates include the 1.1 percent rate reduction approved by the Commission in Decision No. 61104. Additionally, the rates for standard offer customers will be reduced an additional two percent over the next two years in conformance with that Decision. The tariffs identify separately distribution, transmission, metering, billing service, system benefits, market generation charge, regulatory asset charge and an interim transition or competition transition charge, as applicable.

The interim competition charge is determined as follows: A quarterly firm Wholesale Market Generation Charge will be estimated for a 12-month period based on shaping the Palo Verde Nymex futures price for California hourly spot market index plus 3.5 mills. The adder reflects the ancillary services, capacity reserves and other necessary generation costs. I believe these mechanisms will provide the necessary stimulus to the market upon the introduction of competition.

Q. PLEASE DISCUSS THE BENEFITS OF THIS AGREEMENT.

A. I believe them to be significant:

- First, and foremost, the Agreement resolves two major issues crucial to meeting the January 1, 1999 start-date; stranded costs and the unbundled distribution tariff. Without resolution of these two issues retail competition cannot be implemented.
- The Agreement addresses vertical market power concerns raised by some of the parties. Under the Agreement, TEP will divest its generation assets. The formation of Transco will result in the divestiture of APS' transmission assets. Neither TEP nor APS will continue to operate as a vertically integrated utility. The potential for assertion of vertical market power will be eliminated. The key result of these divestitures is that transmission assets are owned by a company without generation and access to such assets will be controlled by an independent third party such as the ISO.
- The Agreement provides for rate stability for TEP's distribution customers by establishing unbundled distribution rates that will remain in effect during the transition period. Additionally, TEP's standard offer customers will receive the benefit of an additional two percent rate decrease during the transition period.
- TEP will continue funding systems benefits charges, including its low income, DSM and renewable programs, at 1997 levels.
- The Transco proposal provides for quicker non-discriminatory open access and movement towards the establishment of the ISO.
- The securitization component will facilitate the financing of the divestiture process, which is an essential component of TEP's ability to divest. Securitization will lower the cost to customers of stranded cost recovery, by funding the payment stream at an investment grade rate of interest.
- The Agreement allows the Commission to retain complete oversight over the entire transaction, as well as over TEP on a going-forward basis.
- The Agreement allows TEP to function as a UDC to concentrate on serving its customers without regard to who supplies its customers with energy.

- The Agreement provides TEP an opportunity to continue rebuilding and maintain its financial integrity thereby resulting in a financially healthy and stable UDC to serve the distribution needs of the customers of Southern Arizona.
- Finally, the Agreement ensures that TEP will not pursue its litigation options with respect to the Commission's ability to implement the Rules, thereby removing a major potential impediment to the introduction of competition.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner - Chairman
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IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. RE-00000C-94-165 **DIRECT TESTIMONY OF DEAN E. CRIDDLE**

On Behalf of
TUCSON ELECTRIC POWER COMPANY

NOVEMBER 20, 1998

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Appendix A - Fitch Reports

I. Introduction

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dean E. Criddle. My business address is 400 Sansome Street, San Francisco, California 94111.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am a partner in the law firm of Orrick, Herrington & Sutcliffe LLP, where I have practiced law since 1976. I am admitted to practice law as a member of the California bar. Since at least 1988, my practice has consisted primarily of providing legal advice in connection with public capital market financings for electric utilities.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The Settlement Agreement between Tucson Electric Power Company ("TEP") and Staff of the Arizona Corporation Commission ("ACC"), dated November 4, 1998 (the "Settlement Agreement"), provides that TEP "shall securitize all regulatory assets and/or stranded costs resulting from the divestiture [of its generation assets]" if securitization will reduce the total costs to customers for regulatory assets and/or stranded cost recovery. My testimony will describe the principal benefits of securitization transactions. It also will describe the principal requirements of national rating agencies. My testimony will not attempt to interpret Arizona law.

Q. WHAT IS YOUR EXPERIENCE WITH SECURITIZATIONS FOR ELECTRIC UTILITIES?

A. I served as lead outside counsel for Pacific Gas and Electric Company in connection with its $2.9 billion securitization transaction completed in December of 1997. This was the first (and remains the largest) securitization transaction completed in connection with the deregulation of generation-related assets and obligations of investor-owned electric utilities.

II. Securitization

Q. WHAT IS SECURITIZATION?

A. Securitization is a special purpose, collateral-based financing method which can provide funding at a much improved rate of interest. In addition, securitization is a financing structure that provides funding through the isolation of specified revenues and/or assets from the general credit of the sponsor (here, TEP) in order to achieve a lower cost of capital than is

available based upon the sponsor's own credit rating. The objective generally is to obtain a "AAA" rating for the securitization from at least two of the three major national rating agencies (Moody's Investors Service, Standard & Poor's, and Fitch IBCA) without adversely affecting the credit rating of the sponsor's other debt and equity securities.

TEP must be able to securitize to finance the cost of divestiture and the termination of its associated debt and lease obligations. It is unlikely that TEP could finance such costs without the specialized financing technique provided by this form of asset-based financing.

For example, a financial institution with an "A" credit rating and a portfolio of single family mortgage loans worth $100 million might organize a special purpose trust or limited liability company (the "special purpose entity" or "SPE") and transfer $2 million worth of mortgages to the SPE in return for all equity interests in the SPE. The SPE then might issue $98 million of SPE notes to the general public and use the proceeds to purchase the remaining $98 million of mortgages from the financial institution. For a fee, the sponsoring financial institution might agree to continue to provide the same billing, collection and administrative services with respect to the mortgages that it performed prior to selling the mortgages to the SPE. Such transactions are designed to isolate the transferred assets from the effects of a possible bankruptcy of the sponsor. Properly structured, the transaction will result in a "AAA" rating from national rating agencies, thereby producing a significantly lower cost of capital than would be available if the sponsor were to issue $98 million of its notes directly, secured by the $100 million of mortgages. It also should avoid any adverse impact upon, and may even improve, the credit ratings of the sponsor's other debt and equity securities (which might well occur if the sponsor were to issue $98 million of debt directly).

Q. WHAT COST OF CAPITAL BENEFITS ARE AVAILABLE TO INVESTOR-OWNED UTILITIES THROUGH SECURITIZATION?

A. Securitization transactions generally allow investor-owned utilities ("IOUs") to substitute low-cost debt financing for higher cost debt and equity financing. IOUs generally are required to report securitizations as debt on their consolidated balance sheets. However, within limits, the rating agencies have indicated that they will treat properly structured securitizations as though they were off-balance sheet transactions because a default by the SPE will result in no financial obligation on the part of the IOU, and because the assets and

liabilities are isolated from the effects of a possible bankruptcy of the sponsoring IOU. Compared with a large corporate debt offering, which could adversely affect the ratings on the IOU's remaining debt and equity securities, securitization provides a cheaper form of financing that does not adversely affect the Company's existing cost of capital.

III. Rating Agency Requirements

Q. WHAT FEATURES MUST BE IN PLACE IN ORDER TO ACHIEVE "AAA" RATINGS?

A. During the last 26 months, each of the three major national rating agencies has released at least one report summarizing the requirements for obtaining a "AAA" rating for securitization transactions in the electric utility industry. The most recent of these are the Special Reports released by Fitch IBCA on September 24, 1998, and October 8, 1998 (the "Fitch Reports"). A copy of the Fitch Reports is attached as Appendix A. Like more general reports previously issued by Fitch IBCA, Moody's Investors Service and Standard & Poor's, the Fitch Reports identify six key legal elements that must be present to achieve a "AAA"-rated securitization:

(a) property right;

(b) irrevocability and State support;

(c) nonbypassability;

(d) bankruptcy remote/true sale;

(e) "true-up" mechanism; and

(f) guidelines for third-party energy service providers.

In California, the only state in which stranded cost securitization transactions actually have been completed, all six of the key legal requirements identified in the Fitch Reports have been addressed either by statute or by regulatory orders. The California Public Utilities Commission's approval of key legal provisions has been confirmed by a decision of the California Supreme Court.

While the California securitizations were based upon enabling legislation, page 4 of the Fitch Report dated September 24, 1998, and page 2 of the Fitch Report dated October 8, 1998, note that electric utility securitization might be achieved in some states without special implementing legislation. Arizona is mentioned as a state where such "administrative

securitization" might satisfy the six key legal requirements based upon general powers granted to the ACC under existing law.

A. Property Right

Q. WHAT KIND OF PROPERTY RIGHT MUST BE CREATED IN ORDER TO ACCOMPLISH A SECURITIZATION?

A. The ACC order must create a legal right of TEP to be paid a specified dollar amount, together with interest at a specified rate on the unpaid balance, the "Transition Property" referred to in Exhibit A to TEP's Application. This legal right must be transferable by TEP to a bankruptcy-remote SPE. It also should be capable of being pledged by the SPE to secure payment of principal and interest in respect of notes issued by the SPE.

B. Irrevocability and State Support

Q. MAY THE ACC REVOKE OR AMEND THE SECURITIZED CHARGE?

A. Yes. However, the rating agencies will not assign a "AAA" rating to Competition Transition Bonds ("CTBs") that are payable solely from the securitized charge unless the ACC agrees not to exercise its right to revoke or amend the securitized charge without making adequate provision for scheduled payments of principal and interest on the CTBs. For example, the ACC order might stipulate that the ACC will not revoke or amend the securitized charge without first arranging for a portfolio of U.S. Treasury obligations to be deposited in an escrow to ensure scheduled payments of principal and interest on the CTBs.

C. Nonbypassability

Q. MAY RETAIL ELECTRIC CUSTOMERS BE EXCUSED FROM PAYING THE SECURITIZED CHARGE TO THE EXTENT THEY GENERATE THEIR OWN ELECTRICITY OR OTHERWISE CEASE TO TAKE DELIVERY OF ELECTRICITY OVER DISTRIBUTION LINES OWNED BY TEP OR BY A SUCCESSOR UTILITY?

A. Yes. However, the rating agencies likely will run "stress case" analyses which test the debt serviceability under various sensitivities or scenarios. For example, they may assume that large numbers of industrial and commercial customers avoid the securitized charge through self-generation or otherwise. The rating agencies might require shorter terms to maturity, declining scheduled debt service, large overcollateralization amounts, or other features that ensure the payment of scheduled principal and interest even in the event of these "stress

cases."

Q. MAY RETAIL ELECTRIC CUSTOMERS BE EXCUSED FROM PAYING THE SECURITIZED CHARGE BY PURCHASING ELECTRICITY FROM A SUPPLIER OTHER THAN TEP?

A. No. The rating agencies will require that the securitized charge continue to be paid by substantially all retail customers who take delivery of electricity over TEP's distribution lines.

Q. MAY RETAIL ELECTRIC CUSTOMERS BE EXCUSED FROM PAYING THE SECURITIZED CHARGE IF TEP'S ELECTRIC DISTRIBUTION SYSTEM IS ACQUIRED BY A MUNICIPALITY OR BY ANOTHER BODY THAT IS NOT SUBJECT TO ACC RATEMAKING JURISDICTION?

A. No. The rating agencies will require that the remaining principal amount of the underlying Transition Property, including accrued interest, become due and payable if a substantial portion of TEP's distribution system is acquired by an entity that is not subject to ACC's ratemaking jurisdiction or if TEP's rates cease to be established by the ACC.

D. Bankruptcy Remote/True Sale

Q. WHAT FEATURES SHOULD BE INCLUDED IN AN ACC ORDER TO ENSURE THAT PAYMENTS ARE MADE ON THE CTBs EVEN IN THE EVENT OF A TEP BANKRUPTCY?

A. It will be crucial to the rating agencies that TEP be treated as making an absolute transfer (sometimes referred to as a "true sale") of its property right to the SPE. It also will be crucial that the SPE not be consolidated with TEP for purposes of bankruptcy analysis.

In order to support the transaction as a "true sale," the ACC order should direct that the securitized charge be displayed as a separate line item on retail customers' bills. The order should clearly state that TEP's transfer to the SPE is an absolute transfer of TEP's interest in the property, such that the securitized charge will not be taken into account in establishing TEP's revenue requirement and interest on the property will not be taken into account as a cost of TEP's capital for TEP ratemaking purposes. Moreover, the securitization transaction should be structured such that all material economic benefits from any increase in value of the property is captured by the SPE (not by TEP), and that all material economic

losses resulting from any decrease in value of the property are borne by the SPE (not by TEP).

In order to avoid consolidation of TEP and the SPE for bankruptcy purposes, the SPE must have at least one independent director and must observe all separate corporate formalities. The SPE also must have sufficient capital or other available funds to pay its own reasonably anticipated administrative and operating expenses as they come due.

E. "True-Up" Mechanism

Q. WHAT IS THE PURPOSE OF A "TRUE-UP" MECHANISM?

A. The purpose of a "true-up" mechanism is to provide for automatic adjustments to the securitized charge as usage of electricity exceeds (or is less than) projected levels in order to match periodic revenues from the securitized charge as closely as possible to the amounts required to be paid on the CTBs. All mechanics and formulas for implementing "true-up" adjustments should be approved in advance by the ACC so that they can be put into effect (and remain in effect) without further action of the ACC.

Q. IS SECURITIZATION OF THE SPECIAL CHARGE POSSIBLE WITHOUT ANY "TRUE-UP" ADJUSTMENT MECHANISM?

A. Perhaps. But without an efficient, self-executing "true-up" adjustment mechanism, the rating agencies probably will require additional overcollateralization, subordinate tranches of CTBs retained by the SPE, or other forms of credit enhancements. These features would make the securitization transaction much less cost effective.

F. Third-Party Energy Service Providers

Q. WILL "AAA" RATINGS FOR THE CTBs DEPEND UPON THE CREDITWORTHINESS OF THIRD-PARTY ENERGY SERVICE PROVIDERS?

A. If third-party energy service providers ("ESPs") separately bill retail customers, or if TEP bills retail customers both for electricity provided by ESPs and for distribution service provided by TEP, it probably will be possible to obtain "AAA" ratings for the CTBs even if the ESPs have poor credit ratings. But if ESPs are permitted to present a consolidated bill to retail customers, with the ESPs being obligated to remit collections of the securitized charge to TEP (or its assignee), creditworthiness of the ESP will become important to the rating agencies. Unless ESPs are required to meet certain credit criteria or post collateral to ensure

that they will remit the securitized charges in a timely fashion, the rating agencies probably will run "stress case" analyses to ensure that scheduled payments will be made to owners of the CTBs even if ESPs fail to remit their collections of the securitized charge in a timely fashion. The rating agencies might require additional overcollateralization, subordinate tranches of CTBs retained by the SPE, or other forms of credit enhancement, any of which would make the securitization transaction less cost effective.

IV. Conclusion

Q. DO YOU HAVE ANY CONCLUDING REMARKS?

A. Yes. Securitization of a separately-stated, nonbypassable charge imposed on all of TEP's distribution service customers, as provided for in the Settlement Agreement, would provide an extremely cost-effective means to finance TEP's stranded costs. This financing technique requires the ACC's advance approval of a special charge, as well as an automatic "true-up" adjustment mechanism, that will remain in effect without amendment until the CTBs have been repaid or until adequate, alternative provision has been made for repayment of the CTBs. Securitization might be the only feasible method available to TEP, whose credit rating is below investment grade, at this time to raise cash sufficient to finance the divestiture of TEP's power plants. It also is expected to result in a significant reduction in TEP's consolidated cost of capital in comparison to the cost associated with TEP issuing a blend of its own traditional debt and equity securities.

Utility Stranded Costs: Rating the Securitization of Transition Tariffs

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This report updates Fitch IBCA Research on "Guidelines for Rating Debt Backed by Regulatory Assets," dated Sept. 30, 1996, available on Fitch IBCA's web site at www.fitchibca.com.

■ *Overview*

In December 1997, the three California investor-owned utilities each completed a securitization through the issuance of debt backed by the right to collect "transition tariffs." Across the U.S., investor-owned utilities in several states, including Illinois, Pennsylvania, and Montana, are poised to issue similar bonds with legislative support. The development of this asset-backed market has tracked the timing of electric industry restructuring, subject to the legislative and political process in each state. The earliest transaction of this type was completed in July 1995 by Puget Sound Power & Light Co. (now known as Puget Sound Energy), which sold the right to collect tariffs relating to energy conservation programs. In 1996, bonds backed by utility surcharges were issued by Spanish and Italian utilities, with additional governmental support. The California transactions have been viewed as setting precedent for broader issuance in this market.

The U.S. electric utility industry is undergoing a fundamental reorganization, under which power generation will become subject to competition while transmission and distribution will remain monopoly activities. As part of this transition, many utilities are requesting compensation for prior investments or commitments that were deemed prudent by investors and would be rendered uneconomic in a competitive market. These investments, commonly referred to as "stranded costs" or "transition costs," may include unrecovered investments in, or costs associated with the closure of, a power plant; maintenance costs of nuclear power facilities; nuclear decommissioning costs; obligations associated with above-market power purchase contracts; the cost of work force retraining; and demand-side management or low-income assistance programs.

In many states, as a matter of public policy, the legislature and regulatory authorities have provided for recovery of utilities' stranded costs through the imposition of a defined surcharge or tariff to be assessed by the utility against its customer base. The resulting right to collect future tariff revenues from utility customers is referred to herein as "transition property."

In states considering securitization, a statute will contain general securitization guidelines that will be supplemented by specific applications for financing orders submitted by the utilities to the state utility commission. The goal of securitization is to reduce the utility's cost of capital, thus improving its ability to operate in a competitive market, and to allow utilities to realize compensation for stranded costs sooner.

It is important to note that statutes establishing transition tariffs will not necessarily provide for the securitization of such tariffs. Furthermore, securitization is only one method of recovery for stranded costs. Many utilities have chosen to recapitalize through divestiture of assets or other forms of reorganization. Also, securitization need not be directly coupled with the identification and compensation of stranded costs. For example, the restructuring statute passed in Illinois permits securitization of a defined transitional revenue stream, without linkage to stranded investment.

Several features differentiate debt backed by transition tariffs from "plain vanilla" asset-backed debt instruments. The establishment of transition property (i.e. the right to collect the future cash flow stream) will depend on a specific statute or body of regulatory procedures rather than standard contract law, such as the Uniform Commercial Code (UCC). Transition property represents a dedication of future revenues; consequently, the creation of the obligation to pay depends on the performance of a service to be rendered in the future. Furthermore, individual utility ratepayers may move into or out of the region or existing customers may increase or reduce their consumption, thereby increasing or reducing overall payments for energy delivery. Final maturities on these bonds may stretch out 10–15 years. The longer the expected maturity, the greater the potential impact business or technology changes could have on the cash flows supporting the bonds.

Key Rating Elements

- ☐ Legal and Regulatory Framework
- ☐ Political Environment
- ☐ Transaction Structure
- ☐ Analysis of the Utility as Servicer
- ☐ Credit Analysis
- ☐ Regional Economic Factors
- ☐ Cash Flow Stress Cases

■ *Legal and Regulatory Framework*

Unlike other asset classes, the tariff-based cash flow stream supporting the bonds is established by legislative or regulatory authority. Thus, the first component in Fitch IBCA's analysis is a thorough understanding of the authorizing legislation and financing orders.

The enabling statute or order will generally provide for the restructuring of the state's electric utility industry by bringing competition to electric generation and, in some cases, certain other utility-related services (e.g. metering, meter reading, and billing).

In states considering securitization, a transition tariff will be established through a statute approved by the state legislature, or by regulatory order approved by the state utility commission, to provide for the recovery of a portion of utilities' stranded costs. It is important to note that utility restructuring legislation (enacted to introduce competition to the generation market) may establish transition tariffs while not allowing for securitization. Some legislation, as in California, provides for securitization of only a portion of the transition charge.

For a ratable securitization, the transition tariff should provide various legal elements that are crucial to the securitization, as detailed in the following sections.

Property Right: Since the asset securing the bonds is a right to a future cash flow stream, the statute or order should establish the future tariff collections as a property right that can be transferred and pledged as a security interest. The transition property will not be governed by the UCC; therefore, the procedures for establishing a first-perfected security interest should also be outlined in the statute or order. The amount of the tariff, as well as the rules for its collection, will be defined in financing orders approved by the regulatory commission in the relevant state.

Irrevocability and State Support: The statute or the regulatory order must establish the transition tariffs as irrevocable, prohibiting the legislature, the commission, or any other agency or governmental entity from rescinding, altering, or amending the tariffs or transition property in any way that would reduce or impair their value. The irrevocability language is an important protection against changing political agendas in the legislative or executive branches of government. Once the bonds have been issued, the tariffs are further supported by the "contracts" and the "takings" clauses of the U.S. Constitution and most state constitutions, which protect against impairment of contracts and taking of property without the provision of adequate compensation.

If the bonds are issued pursuant to specific legislation, the statute will generally contain a state non-impairment pledge, wherein the state agrees that it will not limit or alter the tariffs, transition property, financing orders, or any other right under the bonds until the principal of and interest on the bonds are fully paid or unless adequate compensation has been made to safeguard bondholder rights.

Because the assets securing these bonds are created through the political process and are bound with industry restructuring, the enabling statute and orders will be subject to challenge from opposing parties. While the political process differs from state to state, the enactment of legislation, or issuance of a final commission order, involves a process in which interested parties have the opportunity to challenge or submit amendments to the proposed language. Generally, after a statute is approved by the legislature, and/or an order is issued

Examples of Stranded Costs/Transition Costs

- Above-Market Generation — Nuclear or other generating facilities that will not be cost effective in a competitive environment.
- Non-Utility Generating or Independent Power Contracts — Many of these contracts have been signed with fixed or escalating power prices above current and estimated future power sales prices.
- Regulatory Assets/Social Programs — Catch-all category for deferred charges, nuclear decommissioning costs, conservation programs, employee retraining, and low-income customer subsidies.
- Transaction Costs — The costs of issuing, servicing, and retiring bonds.

by the commission, there is an additional defined period when outside parties can challenge the statute or order through litigation. When this period has expired, the potential for later attack is substantially diminished.

Many states have a ballot initiative process that allows opposition groups to place a petition on the election ballot upon receipt of a given number of voter signatures. When analyzing bonds issued under statute in these states, it is important to ensure the soundness of the federal and state constitutional protections, the irrevocability language, and the state non-impairment pledge. Fitch IBCA analyzes the constitutional protections and issues in each state and requires corresponding legal opinions from utility counsel. In addition, other qualitative factors, such as capital market restrictions, political support, the potential legitimacy of any legal attack, and incentives of all parties involved, should be considered.

Nonbypassability: The transition tariff is usually assessed as a distribution charge, applicable to the monopoly utility service. Therefore, regardless of which power provider generates the energy delivered to the customer, a transition charge will be collected based on delivery service. This type of tariff is frequently referred to as a "wires charge." While customers will be able to choose their power provider, their need to be connected to the distribution system, whether for primary or backup service, will limit their ability to bypass the tariff.

Bankruptcy Remote/True Sale: The statute or regulatory order should protect the bondholders from the interruption or impairment of cash flows in the event of a utility bankruptcy. It should also ensure that the transfer of the transition property will be treated as an absolute transfer, not a pledge, of the seller's right, title, and interest in the property. The statute or regulatory order should also define conditions for a valid, enforceable, and perfected security interest for the indenture trustee.

Fitch IBCA requires legal opinions of utility counsel stating that, in the event of a utility bankruptcy, the transfer of the transition property would constitute an absolute sale rather than a pledge. Thus, the transition property is not considered part of the utility's bankruptcy estate and the court will not order the consolidation of the assets of the special purpose vehicle (SPV) with the utility in the event of the utility's bankruptcy.

True-Up Mechanism: The statute or order may provide a mechanism that would authorize the utility to reset tariffs at least annually. The reset, referred to as the "true-up mechanism" or "true-up," typically adjusts the tariff to a level sufficient to maintain interest payments, scheduled principal amortization, related fees, and any credit enhancement balances. The statute or order may provide for more frequent resets, based on the occurrence of certain events, such as a minimum percentage variance between projected and actual principal amortization. The true-up can increase or decrease the tariff depending on the positive or negative variance of actual tariff payments and/or energy consumption from the utility's projections.

The filing for the true-up mechanism will generally be made with the utility regulatory commission or equivalent agency of the state based on updated sales forecasts for the forthcoming years. It is important that the statute or order neither require discretionary commission approval for the true-up

Legal and Regulatory Framework Checklist

- Establish transition tariff as a property right.
- Nonbypassable for any customers connected to the distribution system within the service territory.
- Irrevocable by subsequent legislatures or commissions; statutory language (if applicable) should include state non-impairment pledge.
- Supported by federal and state constitutional protections.
- Bankruptcy-remote issuer, nonconsolidation of assets with the utility, and a true sale of the transition property.
- Granting of a first-perfected security interest in the transition property to the indenture trustee.
- Review of requirements and mechanics of true-up mechanism (if applicable).
- Guidelines for consolidated billing by third-party energy providers (if applicable).

Administrative Securitization

Utility securitizations, to date, have been preceded by passage of legislation that explains the transactions' legal and structural framework. As detailed in this report, the key provisions included in a securitization statute relate to the irrevocability of a commission finding creating the transition tariff that underlies the securitization, the true sale of the *utility's transition property* to a special purpose vehicle (SPV) or trust, and the remoteness of the SPV or trust from the potential bankruptcy of the involved utility or any entity acting as servicer for the transaction.

It is possible that a valid securitization could be structured without the need for such specific legislative authorization. This technique, called "administrative securitization," seeks to ensure the necessary elements described above based on existing state law or constitutional provision. The idea has received the greatest consideration in states where the legislature has found the enactment of a more traditional authorizing statute to be difficult (New York), or where the utility regulatory commission receives its authority from the state constitution and, thus, is shielded from any attempt by the legislature to limit the commission's powers or modify its decisions (Arizona).

In the absence of specific enabling legislation, the parties formulating an administrative securitization must rely on the general powers granted to a public utility commission under existing law. Accordingly, the transaction structure might differ depending on the specific legal circumstances of the state in which the transaction will occur. Regardless of the form of a particular deal, its legal bases will likely be underpinned by one or more of the following legal theories that would hold that future action by either the commission or the legislature to adversely affect bondholder rights is prohibited:

- The federal or state constitution forbids the taking of bondholder property without just compensation.
- The federal or state constitution forbids state actions that *impair contracts*.
- The federal or state constitution forbids state actions that are arbitrary and capricious.
- The state, having achieved its public policy goals through the bond issuance, is estopped from modifying the rights previously granted to bondholders.

Whatever the legal theory espoused, the use of administrative securitization will be an issue that is not governed by any existing precedent within the courts of any state in which the concept is proposed. Accordingly, Fitch IBCA fully expects that the authorization of such securitization by a state utility commission will be appealed to the state court of appropriate jurisdiction for a determination that the structure proposed for the transaction is legitimate. If such judicial finding is returned in the affirmative, Fitch IBCA would see no bar to analyzing the deal in the manner outlined within this report to determine whether the transaction, as structured, meets the requirements for an 'AAA' rating. In the unlikely event that an administrative securitization order is unchallenged, Fitch IBCA would investigate the specific state law provisions to determine if all of the necessary elements for a securitization are supported.

nor limit the resulting tariff to a level insufficient to ensure debt repayment. If the regulatory framework does not provide a true-up mechanism, Fitch IBCA will require overcollateralization, subordinated tranches, or other forms of credit enhancement.

Third-Party Energy Providers: In many states, third-party energy providers (i.e. non-utility power generators, energy marketers, and independent brokers) will be granted the right to perform "consolidated billing," i.e. the right to bill customers for all services rendered (including distribution services and transition tariffs) and remit payment back to the utility. If the statute or order allows for third-party consolidated billing, it should also *impose minimum* credit or collateral requirements on parties wishing to assume this service. Generally, such guidelines will include setting of minimum credit standards; posting of cash collateral to cover the maximum period for which revenues are at risk; and/or requiring that the third party assume personal liability for billed amounts, regardless of collections. For additional information on third-party energy providers, please see Fitch IBCA Research on "California Direct Customer Access Plan," dated Nov. 18, 1997, available on Fitch IBCA's web site at www.fitchibca.com.

■ *Transaction Structure*

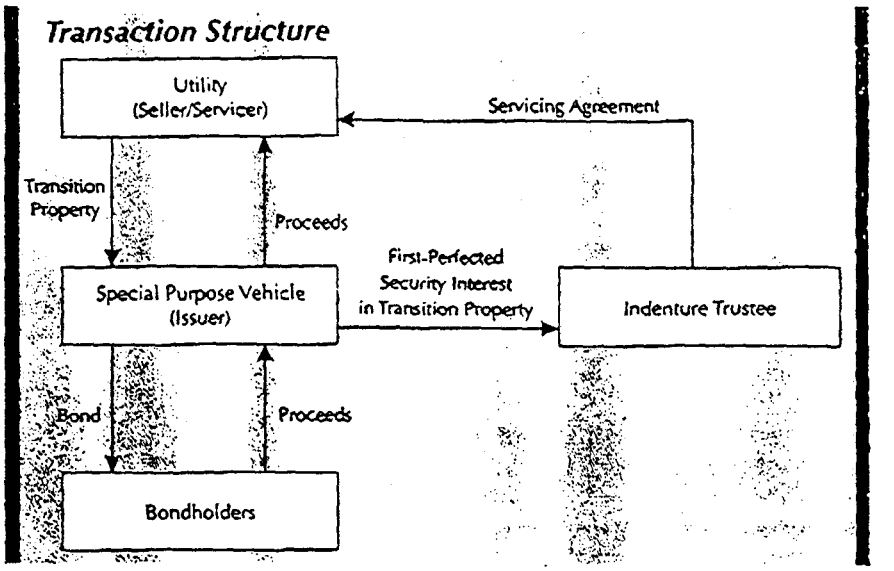
At closing, the utility, as seller, will transfer its ownership interest in the transition property to a bankruptcy-remote SPV (the issuer). To ensure the true sale, all conditions of the enabling statute or regulation must be fulfilled. The SPV, pursuant to its statutory or regulatory authorization, will grant a first-perfected security interest in the transition property to a trustee on behalf of the bondholders. For tax purposes, the transaction will generally be classified as debt of the selling utility and a letter from the Internal Revenue Service confirming this classification may be received prior to issuance. The bonds

are generally classified as debt of the utility for accounting purposes as well. The chart at right summarizes the basic structure for these transactions.

The notes issued may be tranched into multiple classes with varying maturities. The principal amortization schedule can be structured as level, mortgage-style, or variable payments. The key to assessing the appropriate amortization schedule is to ensure that proposed payments are consistent with forecasted seasonal fluctuations in collections. While the projected principal amortization schedule will be established at closing, principal shortfalls will generally not trigger a default under the transaction documents. If there is a periodic reset, the true-up mechanism should encompass any prior shortfalls in interest, principal, fees, or any overcollateralization account balances so that principal shortfalls in a given year should be compensated by tariff adjustments in the following period.

Fitch IBCA will evaluate the interrelationship of all aspects of the structure in developing the rating for the bonds. However, certain structural factors will contribute to achieving the highest ratings. For example, the final maturity date for the bonds should fall within the maximum term of the tariff, as defined by statute or order. Back-ended principal payments (i.e. mortgage-style amortization) may strain cash flows in the early periods and increase risk toward the end of the term. Also, given the technology risks associated with the transactions, longer term bonds will be subject to higher cash flow stress scenarios than bonds of shorter duration.

On a qualitative level, Fitch IBCA prefers the tariff to be a relatively small percentage of customers' overall bills and/or that the utility's total rates conform to the regional average. If the transition charge is large or total rates are high, customers may have a greater economic incentive to invest in alternative energy technologies, reduce their consumption, become self-generators, or seek political or legal overturn. This risk is somewhat mitigated in states where total customer rates are capped.



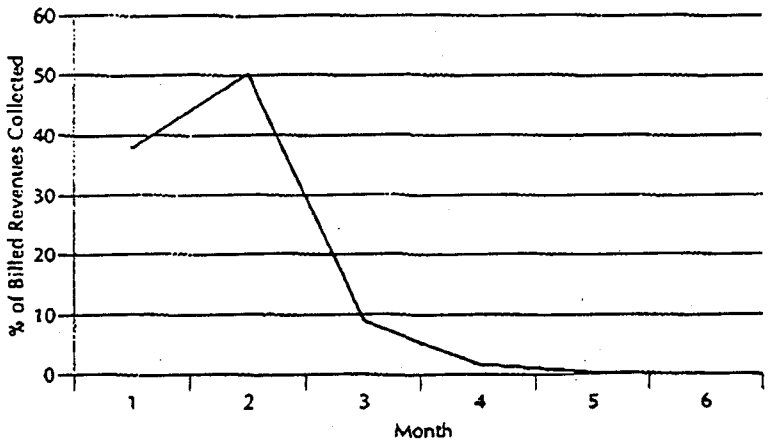
Credit Enhancement: In traditional asset-backed analysis, the level of credit enhancement determines the rating on the securities. However, traditional credit enhancement for debt backed by transition tariffs tends to be relatively small (usually 1%–3% of the initial principal amount). This reduced amount of enhancement is sufficient to achieve 'AAA' ratings for bonds structured with the true-up mechanism since cash flow variability is mitigated by the true-up mechanism and the essential nature of electric service.

When a true-up mechanism adjusts the tariffs at least annually, any cash flow shortfalls will ideally be captured by the end of the following year. Traditional forms of overcollateralization provide some liquidity in the early stages of the deal and greater support toward the end of the transaction. In the later years, the opportunities to true-up, and, thus, the flexibility to recoup principal shortfalls, become fewer. At this point, funded overcollateralization makes up a larger percentage of the outstanding principal balance of the bonds, more closely approaching market enhancement levels for 'AAA' rated bonds in other asset classes.

Sizing of the credit enhancement will depend on the terms of the true-up mechanism, the bond structure, and the strength of the cash flows. Bonds structured with back-ended principal amortization, for example, may require higher credit enhancement in the early years to compensate for lower interest coverage. For bonds structured without a true-up mechanism, higher enhancement levels will be required.

Collection Accounts: An indenture trustee will establish collection accounts into which all tariff collections will be deposited. The frequency of the utility's deposits to the collection accounts will depend on commingling provisions, as described in Utility as Servicer on page 6. Funds held in these accounts will pay expenses, fees, principal, and interest, as well as fund any overcollateralization requirements on a monthly, quarterly, or semiannual basis. Any excess cash collected will normally be held in a reserve account and, if appli-

Sample Collections Curve



cable, incorporated into the calculation of the following year's true-up.

Collections Curve: Some bond structures may require the utility to remit cash to the trustee based on a "collections curve," regardless of the actual cash collected. A collections curve specifies the required percentage of each bill that must be remitted to the trust in each of the five or six months after the bill is issued. The curve is calculated based on historical average percentage of bills collected by month after issue, with percentages adjusted annually based on updated collections experience.

■ *Utility as Servicer*

The utility will normally act as servicer for the bonds, performing activities such as billing, calculating and collecting the tariff, calculating and filing for true-up adjustments, and sales and usage forecasting. When third-party energy service companies perform consolidated billing, the utility functions as master servicer to consolidate and supervise collection from third parties. Electric utilities will normally have extensive experience in the functions necessary to act as servicer. Furthermore, a utility will frequently have the ability to terminate service due to nonpayment. Thus, even if the utility's credit rating is 'BBB' or lower, it will generally be the optimal servicer for the transaction. Fitch IBCA's due diligence on each utility proposing to act as servicer on a transaction incorporates a review of the utility's forecasting, credit assessment, collections, delinquencies, writeoffs, billing systems, commingling risk, and the availability of alternate servicers, as summarized below.

Forecasting: Since scheduled principal amortization will be based on the utility's sales forecasts, it is important to assess the utility's forecasting ability and accuracy. Utilities generally maintain sophisticated econometric models that relate historical values of energy variables to measures of weather, the economy, and the number of customers. Fitch IBCA reviews the utility's historical sales forecasts and the variances to actual results to determine the peak unfavorable forecast variance, as well as the reasons for such variance, for each customer class included in the securitization. These results are used in the cash flow stress scenarios, as outlined on page 8.

Credit Assessment: Under most state regulatory guidelines, a utility will be required to provide service to all customers regardless of creditworthiness. In some states with dramatic swings in temperature, the utilities may be forbidden from disconnecting service during extremely hot or cold seasons. For these reasons, the key factor in a utility's credit assessment process will be the criteria for requiring additional security from riskier customers. If service cannot be denied, most utilities will require a security deposit for new customers or those who pose a greater credit risk.

Collections, Delinquencies, and Writeoffs: The utility should have a well established process for pursuing and collecting delinquencies. However, since customers consider electricity an essential service, historical chargeoff and delinquency rates for utilities tend to be relatively low. It is not unusual for utilities to experience 0.50% average chargeoffs for a 20-year period.

In the deregulated energy services market, an important factor will be the distribution utility's continued ability to disconnect service for nonpayment, even if a third-party energy provider is supplying electricity. In some states, the ability to disconnect may be delayed, especially if a third party is providing consolidated billing.

Billing Systems: Under the current system of "bundled" bills, utility customers receive a bill for one amount incorporating various tariffs, taxes, and surcharges. In the competitive market, most utilities will be required to offer "unbundled" bills, explicitly breaking out bill components. The utility's billing systems must be able to incorporate multiple components of billing information. As part of the due diligence process, Fitch IBCA will review the utility's billing systems to ensure that they are adequately prepared to handle the complexities associated with assessing the transition tariffs and tracking collections.

Commingling: The utility's ability to commingle funds will usually be based on its senior debt rating. Generally, utilities with a short-term rating of 'F2' or above will be permitted to commin-

Servicer Checklist

- ❑ Forecasting methods and accuracy.
- ❑ Procedures for assessing customer credit.
- ❑ Collections process, notice, and disconnection.
- ❑ Historical delinquency and chargeoff data.
- ❑ Billing systems.
- ❑ Commingling of securitized tariffs.
- ❑ Requirements and fees for alternate servicers.

gle funds for 30 days prior to remitting payment to the trust. However, if the utility is a qualified servicer with a short-term rating below 'F2', commingling risk may be mitigated by limiting commingling to a maximum of two days, collecting all receipts through a lock box, or requiring a letter of credit equivalent to 30-day maximum collections.

Alternate Servicers: While a sub-investment-grade utility may be an acceptable servicer based on its operational qualifications, the transaction should provide for the right to replace the utility with an alternate servicer in the event of a decline in credit rating, insolvency, or the failure to perform any of the duties of servicer. The transaction should incorporate a servicer fee sufficient to adequately compensate a backup servicer that takes on this role. It is particularly helpful if the legislature or regulatory order places an obligation on the part of any successor to the utility to invoice and collect on behalf of the bondholders.

■ Credit Analysis

Since cash flow supporting the bonds will be generated by payments from all or designated categories of customers in the utility's service territory, it is important to analyze the composition of the service territory to determine the size and usage level of the customer base, customer delinquencies, regional economic sensitivities, and weather-related seasonality.

Customer Base: The size and variability of the customer base will have a significant potential impact on the cash flows to the bonds. Fitch IBCA reviews a number of economic factors in its analysis of the customer base, including: the size and shape of the service territory (the geographic footprint); the diversity of the customer pool; the change in housing starts during recessionary periods; exposure to key industries; cyclicality of key industries; historical recessionary bankruptcy data; the municipal rating of any major cities within the service territory; and the existence of any major universities or military bases in the territory.

The residential segment will provide a high level of customer diversification, similar to that found in credit card receivables. Since the tariff will be assessed against a household rather than an individual, it is assumed that the majority of residents moving away from a service territory will be replaced by new residents. Thus, the residential segment will tend to be a large, diversified, and relatively stable source of cash flow.

The utility's commercial and industrial customers could potentially represent significant concentration in the customer base. These customers will tend to be fewer in number and contribute higher tariff revenues per account than those received from residential customers. Industry concentration should also be assessed. Fitch IBCA incorporates the risks associated with customer concentrations into its cash flow stress tests.

Cyclical and Seasonal Patterns: Billed revenues from residential and small commercial customers tend to show minimal sensitivity to economic cycles. In the short term, the greatest historical changes in residential and small commercial usage have been due to weather. Thus, weather patterns often drive the cash flow projections and, consequently, the amortization structure of the bonds. In the long term, the availability of energy-efficient appliances, trends in energy conservation, and the availability of new energy-consuming technologies will likely affect these customers' usage patterns.

Large commercial and industrial customer revenues show greater sensitivity to economic cycles. Such sensitivities should be incorporated into cash flow stress scenarios, as appropriate.

Self-Generation and Alternative Technologies: Because the tariffs will be assessed upon distribution services, the market entrance of alternative energy providers should not affect tariff receipts. However, customers could potentially avoid payment of the transition tariff by performing energy generation on site and disconnecting completely from the distribution grid. The risk that customers will use new and existing technologies to generate power for their own use is referred to as "self-generation."

Given current available technology, Fitch IBCA considers it unlikely that a significant portion of the residential account base will implement self-generation immediately or that alternative technologies will develop sufficiently in the next 10 years to allow for widespread disconnection from the grid. Self-generation in the industrial and large commercial segments, where large energy usage and greater access to capital would make developing a generation system more feasible, is somewhat more likely. Fitch IBCA assumes that the risk of self-generation, driven by the development of new technologies, has the potential to increase substantially beyond a 10-year horizon.

■ Cash Flow Models and Stress Cases

While the form of cash flow models will vary based on the structure of the bond, statutory and regulatory framework, and

amortization schedules, models will address fundamental credit issues common to all securities in this class. These issues include: the forecast customer base (by customer class); tariff levels for each customer class; energy consumption by class; assumptions on collections and chargeoffs; any true-up mechanism and any overcollateralization.

Basis for Methodology: Several factors could potentially reduce the cash flow to the bonds, including economic recessions, loss of large industrial customers, demographic shifts, increased use of self-generated energy sources driven by technological advancements, and errors in forecasting. Fitch IBCA's cash flow stress methodology aggregates these multiple risks and applies a single variance percentage to cash collections. Actual stress cases are described below.

'AAA' Stress Case: Fitch IBCA's 'AAA' stress case stresses four model variables, each of which is meant to incorporate multiple risk factors described above and resulting in a reduction in cash flows below projections.

- Base Error — The first stress variable is applied as a base error to projected revenues. This base error is intended to incorporate the impact of an economic recession, extreme weather changes, changing usage patterns, or general demographic shifts. The base forecast error will equal between 2.0 times (x)–3.0x the historical 20-year peak positive forecast variance. The multiple used and the length of historical data required will vary based on the term of the transaction and the underlying credit risks.
- Self-Generation/Technology Risk — Fitch IBCA assumes that technological uncertainty increases over time, especially for commercial and industrial customers. This would subsequently increase the risk of self-generation as greater technological options become available. To incorporate this risk, Fitch IBCA will assume that the base error increases exponentially over the term of the bonds, based on the perceived risk of self-generation for the utility's customer base.
- Delinquency Rates — To incorporate the effects of delinquency rates on forecast collections, Fitch IBCA will review the utility's historical delinquency experience and apply a multiple of the highest delinquency period. If the transaction uses a collections curve, Fitch IBCA will assume delays in the collection curve.
- Chargeoffs — Despite utilities' historically low chargeoff ratios, Fitch IBCA will apply chargeoff ratios at 5.0x the 20-year historical peak chargeoff. Again, the historical data required may vary based on the credit quality and term of the deal.

Consolidated Billing Default Case: Fitch IBCA will review the credit guidelines established in the financing order for third-party energy providers performing consolidated billing to determine the transactions' maximum exposure to third-party collections. To test the impact of a potential third-party default, the second stress case assumes that third parties take over billing for a large percentage of the customer base and default every year for the entire term of the bonds. The length of the assumed default, and the percentage of the customer base affected, will vary based on the third-party commingling restrictions contained in the statute or order.

Break-the-Bond Case: The third sensitivity strives to test the amount of stress necessary to force an event of default under the bonds. The results of this scenario should be so severe as to be outside what would be considered reasonable for an 'AAA' stress. The exact cases developed to achieve this goal will vary by transaction.

For additional information on this asset class, please refer to Fitch IBCA Research on "California Infrastructure and Economic Development Bank Special Purpose Trust PG&E-1, SCE-1, and SDG&E-1" dated Jan. 12, 1998, Feb. 4, 1998, and March 19, 1998, respectively. All reports are available on Fitch IBCA's web site at www.fitchibca.com.

Credit Analysis Checklist

- ☐ Composition of customer base.
- ☐ Customer concentrations in commercial and industrial segments.
- ☐ Regional industry concentrations.
- ☐ Strength of regional economy.
- ☐ Geographic footprint.
- ☐ Seasonality and cyclicality.
- ☐ Development of alternative energy generation technologies.
- ☐ Disconnection from the power grid by self-generating customers.

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Issues Addressed in this Report

Rating Transition Bonds

- Risk of judicial overturn or ballot referendums
- Securitization without special legislation
- Technology risk
- Size of transition charges and total price

Implications of Securitization for Utility Credit

- Stranded cost recovery
- Leverage and adjusted financial ratios
- Corporate debt versus transition bonds
- Overall effect on the utility credit rating

For more information, please see Fitch IBCA Research on "Utility Stranded Costs: Rating the Securitization of Transition Tariffs," dated Sept. 24, 1998, available on Fitch IBCA's web site at www.fitchibca.com.

■ *Rating Transition Bonds*

Can the cash flow stream servicing transition bonds be adversely affected by judicial overturn, voter referendum, or ballot initiative?

Since the assets securing these bonds are created by a political process involving legislative or regulatory commission actions, the enabling statute and/or regulatory orders are subject to challenge from opposing parties. While the political process differs from state to state, interested parties generally have the opportunity to challenge or suggest amendments to the proposed statute or regulatory order. Also, after the passage of legislation or the issuance of a regulatory commission's financing order, there is an additional defined period when outside parties can bring a legal challenge against the statute or order. When this defined period has expired, the opportunity to challenge the statute or regulatory order typically diminishes.

Some states have a ballot initiative process permitting voters to place a petition on the election ballot upon request by a given number of voters. A group in California has qualified a ballot initiative for the November 1998 election that seeks to prohibit future utility transition tariff securitization and the collection of transition charges, limit the ability of the three California investor-owned electric utilities to recover costs for non-nuclear generation plants, and prohibit assessment of charges to recover costs of nuclear-related assets. In this situation, the securitization bonds were sold before the initiative was qualified. Fitch IBCA believes that federal and state constitutional protections against impairment of contracts and taking of property without adequate compensation would lead a court to uphold the continuing collection of the dedicated transition tariff backing the bonds even if a majority of voters approve the ballot initiative. Another possible source of protection for bondholders is court enforcement of the State of California's pledge to take no action that would impair bondholders' rights without making adequate provision for the protection of bondholders.

A different scenario is playing out in Massachusetts, where a ballot referendum in November 1998 will challenge the utility restructuring law passed in November 1997. No transition securitizations will have occurred in Massachusetts prior to the vote on the referendum. A successful vote on the referendum likely will eliminate the pos-

sibilityof securitization for Massachusetts investor-owned utilities. However, if the referendum is defeated, the tariff securitization is likely to proceed.

California, Pennsylvania, Illinois, Massachusetts, and Montana have approved specific statutes authorizing securitization. Is it possible to securitize transition charges without a special law?

There may be circumstances in which a utility securitization can be structured without the need for specific legislative authorization. This technique, called "administrative securitization," relies on existing state law or constitutional provisions to ensure several issues that would otherwise be addressed in special legislation. These matters include the irrevocability of a regulatory commission order creating the transition tariff, the true sale of the utility's right to collect the transition tariff to a special purpose entity (SPE), and the remoteness of the SPE from the potential bankruptcy of the utility or any entity acting as servicer for the transaction.

In the absence of new legislation, the parties formulating an administrative securitization must rely on the general powers granted to the public utility commission under existing law. Accordingly, the transaction structure might differ depending on the specific legal circumstances of the state in which the transaction will occur. One or more of the following legal theories is likely to form a foundation for the legal argument that future action by either the commission or the legislature to modify bondholder rights is prohibited.

- The federal and/or state constitutions forbid the taking of bondholder property without just compensation.
- The federal and/or state constitutions forbid state actions that impair contracts.
- The federal and/or state constitutions forbid state actions that are arbitrary and capricious.
- The state, having furthered its public policy objectives (i.e. competition in electric service and direct customer access) through the involvement of bond investors, is estopped from modifying the rights granted to those investors.

Fitch IBCA fully expects that the authorization of administrative securitization by a state utility commission will be appealed to the state court of appropriate jurisdiction to determine that the structure proposed for the transaction is legitimate. If the judicial outcome is positive, Fitch IBCA would apply its typical criteria for transition bonds to see if the transaction as structured meets our rating requirements.

How does Fitch IBCA factor technology risk into transition bond ratings?

Fitch IBCA takes into consideration available and developing alternatives to electricity distributed over the utility network and the likely effect on consumption of electricity over the life of the transition bonds. In most cases, the transition tariff supporting the securitization bonds is formulated as a distribution charge, and customers will continue to be subject to the charge as long as they have any connection to the distribution system, whether for primary or backup service. Some states have considered an "exit charge" that a customer would pay upon becoming a "self-generator," but other states have rejected such a charge. Assuming that there is no exit fee, a customer may avoid payment of the tariff by using existing or new technologies to perform energy generation on site and disconnect completely from the distribution grid.

Currently, industrial and large commercial customers have the greatest ability and motivation to invest in equipment or new technologies to lower their electric bills. Small gas-fired turbines, fuel cells, and photo-voltaics are examples of on-site generation alternatives that could become commercially competitive in certain regions of the U.S. within the next 10 years. Fitch IBCA considers it unlikely that residential customers could implement self-generation immediately or that alternative technologies will become so affordable in the next 10 years to allow for widespread disconnection from the grid. Customers of any class or size could invest in more efficient equipment for energy conservation and reduce the base of sales upon which the tariff is collected. A substantial decline in the consumption of electricity could stress the economics of the securitization transaction.

Fitch IBCA assumes that the risk of self-generation or use of alternate technologies will increase substantially beyond a 10-year horizon, especially if the total cost of electricity distributed over the utility network is high. In cash flow models and stress cases, Fitch IBCA applies a loss factor that aggregates the various risks affecting the collection of the securitized tariff (the "base error"). To incorporate potential technology risk, the base error is increased exponentially over the term of the bonds. The forecasted rate of consumption lost due to new applications of technology will be higher for large commercial and industrial customer accounts than for residential accounts.

Does the size of the securitized transition charge or the absolute level of electricity prices have any effect on the credit of the transition bonds?

Demand for electricity tends to vary depending on relative price. The higher the total all-in cost of distributed electricity, the greater the economic incentive for an electricity consumer to reduce consumption or install new technology. Also, the larger the transition charge, the greater the incentive for customers to apply political pressure or seek legal recourse to try to avoid paying the charge. Consequently,

the credit of the transition bonds is qualitatively improved if the transition charge is relatively small and if the total cost of distributed electricity is not high. Furthermore, the longer the duration of the transition charge, the greater the economic incentive for customers to make investments to reduce consumption or self-generate. The ideal circumstance is a relatively small transition charge and a moderate all-in electricity price for a short period (five years or less), while the worst case is a large transition charge and a high all-in electricity price for a long duration (more than 10 to 12 years.) Practically speaking, most transactions will fall somewhere in between.

In some cases, the charge is high in the early years and diminishes over the course of the transaction, while in other cases, the securitized transition charge is level or increases over time (i.e. charges are back-ended). Back-ending the recovery to later years increases bondholders' exposure to changes in electricity consumption or commercialization of alternate technologies.

■ *Implications of Securitization for Utility Credit*

Is securitization the only way to recover utility stranded costs?

Securitization is one of several methods for recovering investments rendered uneconomic as a result of restructuring the utility business. Regulators may authorize stranded cost recovery via a transition charge collected over time or a rate freeze over a defined period without securitization. However, this type of recovery is subject to regulatory and political risks of a future change in tariffs. With securitization, the utility receives cash immediately and the bonds establish a third-party contract that benefits from constitutional protection; thus, potential political and regulatory risks are substantially limited.

Another method to recover stranded costs is to delay implementation of open access until all existing generation investments and regulatory assets have been amortized in the normal course of business, a strategy that appears to be the favored course in many states, whether by conscious intent or inaction.

Does securitization result in excessive leverage for the utility? How does Fitch IBCA treat the financial statements of the utility after a transition bond issue?

Fitch IBCA does not view bonds arising from the securitization of a dedicated transition tariff as utility debt. If the transition bonds are reported as debt on the utility's consolidated financial statements, Fitch IBCA deducts the securitization bonds and associated revenues, interest expense, and principal amortization from the utility's financial statements and ratios. This approach is predicated upon the view that transition bonds are not a permanent layer of utility capital; the debt is self-liquidating over a defined transition period from a defined cash flow stream that is not available to utility bondholders or other creditors.

By way of background, even though a securitization is legally and economically structured as a "true sale," it is likely to appear as debt in the utility's consolidated accounting statements. The staff of the chief accountant's office of the Securities and Exchange Commission concluded in February 1997 that a utility's right to collect a transition tariff does not qualify as a financial asset pursuant to Financial Accounting Statement 125 ("Sales of Financial Assets"). Thus, the reported financial statements of a utility that has securitized its transition tariff are likely to overstate debt as well as revenues and cash flow available to the utility.

Comparing reported financial measures with the adjusted measures over time produces a better picture of the underlying trends of the utility company.

Two adjusted financial measures helpful to understand utility leverage are adjusted debt to adjusted total capital and adjusted debt to adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA). Fitch IBCA also analyzes adjusted interest coverage ratios (adjusted pretax income to adjusted interest and adjusted EBITDA to adjusted interest). The adjustment calculations are explained in the table on page 4.

It is important to note that the securitization is generally part of a broad restructuring of the utility company that may entail rate reductions, a rate freeze or rate cap for a defined number of years, accelerated recovery of assets, asset divestiture, and the retirement of debt or equity securities in varying proportions depending on the company's longer term capitalization objective. The utility's business and corporate strategy will not stand still over the transition period. All these factors will have a profound effect on the company's leverage and financial condition during the transition period and beyond.

Does the securitization of a dedicated revenue stream supporting the transition bonds result in the effective subordination of the utility's corporate bonds?

While there is no actual subordination of the utilities' debt to the securitization debt, the separate revenue stream dedicated to the rate reduction bonds is more secure than the utility's general revenue stream because of the constitutional protection of contract rights and against the confiscation of property. A utility's revenue stream is subject to variation based on weather and operating performance and is subject to political and regulatory risks. An unanticipated rate reduction or drop in consumption will adversely affect the utilities' debt, while the credit of the rate reduction

Calculating Adjusted Financial Measures

Measure	Adjusted Measure
Debt	Total debt on the balance sheet is reduced by the outstanding amount of transition bonds
Total capital	Sum of adjusted debt plus common and preferred equity
Assets	Deduct from assets an amount equal to outstanding transition bonds; the deduction may be applied to specific asset accounts or as an adjustment to total assets
Revenues	Deduct from reported electric revenues the tariff revenues dedicated to interest expense and principal amortization of transition bonds (generally disclosed in a footnote)
Operating income Pretax income EBITDA	To compute adjusted operating income, adjusted pretax income, and adjusted EBITDA, the adjustments applied to reported revenues are carried down as a direct reduction to each of these adjusted measures
Interest expense	Deduct from reported total interest expense the interest expense attributable to transition bonds (generally disclosed in a footnote)

EBITDA – Earnings before interest, taxes, depreciation, and amortizaton.

bonds may continue unimpaired. The rate reduction bonds are more effectively insulated against these pressures. Consequently, the difference in the ratings of the securitization bonds compared with utility corporate debt ratings relates to the constitutional and legal protections available to the investors in the securitization bonds, rather than to credit enhancement from the subordination of the utility's corporate debt.

Some utility fixed-income analysts have expressed concern that the utility's residual cash flow stream may be more volatile after securitization than before. This could be the case if the utility's total tariff is capped and the securitized transition tariff represents a large percentage of the total. There is no rule of thumb for the maximum size of securitization transactions or maximum percentage of total revenues dedicated to servicing the transition bonds. Fitch IBCA reviews each transaction on a case-by-case basis to determine if the utility credit is exposed to greater risk as a result of securitization.

Does securitization strengthen or impair a utility's business outlook and credit rating?

In most cases, the outcome of a securitization transaction will be positive or neutral to the credit of the utility, with the largest benefits accruing to utilities with large stranded costs and low credit ratings before securitization. A utility's credit will be affected by industry restructuring, deregulation of generation, mergers or acquisitions, or asset divestitures during the transition period. On the positive side, the quality of utility cash flow may be significantly better after the securitization and restructuring because of the lower level of fixed costs and reduced regulatory and competitive risk in the generation business unit. On balance, Fitch IBCA believes that the credit impact is likely to be favorable for most utilities with material stranded cost exposure.

While most of the benefits relate to the generation business, there are some possible disadvantages of an excessively large and long-lasting transition charge for the future distribution utility. Should the distribution utility need to implement new distribution tariff approaches, the securitization transaction would be difficult, if not impossible, to unwind. High distribution fees will provide a greater incentive for consumers to invest in new capital equipment to reduce or replace the consumption of electricity distributed over the utility network, as previously described in the section on technology risk factors. This risk is likely to be modest if the transition charge is of relatively short duration (for example, six to eight years).

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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner - Chairman
RENZ D. JENNINGS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY.	DOCKET NO. E-01933A-98-0471
IN THE MATTER OF THE FILING OF TUCSON ELECTRIC POWER COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1602 et seq.	DOCKET NO. E-01933A-97-0772
IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY	DOCKET NO. E-01345A-98-0473
IN THE MATTER OF THE FILING OF ARIZONA PUBLIC SERVICE COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1601 et seq.	DOCKET NO. E-01345A-97-0773
IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. U-00000C-94-165 **DIRECT TESTIMONY OF JOHN G. PATON**

On Behalf of
TUCSON ELECTRIC POWER COMPANY

NOVEMBER 20, 1998

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EXHIBITS

Exhibit A List of Recently Announced Utility Auctions

Exhibit B List of Recently Completed Utility Auctions

1 I. **Introduction And Purpose**

2 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

3 A. John G. Paton, New Harbor, Inc., 280 Park Avenue, East Tower, 27th Floor, New York, New
4 York, 10017.

5 Q. WHAT IS NEW HARBOR, INC.?

6 A. New Harbor, Inc. ("NHI") is an investment bank that specializes in financial advisory
7 services for the electric, gas and water industries. The firm was founded in June 1993 and is
8 comprised of experienced investment bankers from First Boston, Kidder, Peabody, Lehman
9 Brothers, Merrill Lynch, Morgan Stanley and Salomon Brothers. Its Managing Directors
10 have accumulated over seventy years of experience in the investment banking and financial
11 advisory industry, and have worked with almost every major electric and gas utility in the
12 United States. Their collective work experience includes a broad range of assignments from
13 strategic advisory, divestiture of assets, mergers and acquisitions, bankruptcy and out-of-
14 court restructurings to project finance, equity research, and debt and equity financings.

15 Q. WHAT IS YOUR POSITION WITH NEW HARBOR, INC.?

16 A. I am currently a Managing Director. My responsibilities include directing and overseeing all
17 aspects of investment banking transactions, primarily in the strategic and restructuring areas.
18 These activities include transaction structuring, auction design, valuation, negotiations, etc.

19 Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND YOUR BUSINESS
20 EXPERIENCE AS THE SAME PERTAIN TO YOUR POSITION.

21 A. I received a Bachelor of Mathematics degree in 1980 from Waterloo University in Kitchener-
22 Waterloo, Ontario, Canada. I am a Chartered Accountant, having been admitted by the
23 Canadian Institute of Chartered Accountants in 1982. I received Masters of Business
24 Administration and Bachelor of Laws degrees in 1986 from the University of Western
25 Ontario in London, Ontario, Canada.

26 I worked as a public accountant in the audit and tax area of a predecessor firm to Peat
27 Marwick Mitchell in Toronto, Ontario, Canada from 1977 through 1982. After completing
28 my graduate degrees in 1986, I joined Salomon Brothers Inc in New York City. While at
29 Salomon Brothers, I was part of the Mergers and Acquisitions Group, specializing in electric
30 . . .

and gas utilities business combination transactions, defense, restructurings and bankruptcy advisory.

I left Salomon Brothers in February of 1992 to join Barr Beatty Devlin and Co., a strategic financial advisory firm specializing in gas and electric utilities. In July 1993, Jay Beatty and I left Barr Beatty Devlin to form NHI.

Q. PLEASE DESCRIBE ANY OTHER BUSINESS EXPERIENCE OR BACKGROUND AS IT RELATES TO THE DIVESTITURE OF THE GENERATING ASSETS OF TUCSON ELECTRIC POWER COMPANY ("COMPANY" OR "TEP").

A. I have been involved in the auctioning of large generating stations on behalf of U.S. electric utilities preparing for the deregulation of the power supply function. I personally directed the auction of approximately ten thousand megawatts of gas-fired generating capacity on behalf of Southern California Edison Company. I am currently conducting the sale of the 1,340 MW Centralia, Washington coal-fired mine-mouth generating station on behalf of the eight investor-owned and municipal utility owners, in addition to several other yet to be publicly announced divestitures.

Q. PLEASE DESCRIBE ANY BUSINESS EXPERIENCE AND BACKGROUND RELATED TO ELECTRIC UTILITY DIVESTITURES.

A. During the course of my career, I have been involved in several major mergers, acquisitions, and restructurings in the utility business, including the Entergy/GSU and San Diego/SCEcorp combinations and the bankruptcy cases of Public Service Company of New Hampshire, Eastern Utilities Associates and its wholly-owned nuclear power subsidiary, and EUA Power Corporation. More recently, I have been involved in representations of El Paso Electric Company, for both its bankruptcy case and proposed merger with Central and Southwest Corporation, as well as the Official Committee of Unsecured Creditors of the Columbia Gas System, Inc., and PacifiCorp in its acquisition of PowerCor in Victoria, Australia.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The primary purpose of my testimony is to discuss the various methods of divestiture considered by TEP and the rationale behind the selection of sale by auction.

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II. What is the Preferred Method of Divestiture for Tucson Electric Power Company?

Q. WHAT ALTERNATIVE METHODS OF DIVESTITURE WERE EVALUATED BY NHI AND TEP?

A. NHI, in conjunction with TEP, evaluated a variety of possible means of divesting the generating assets of TEP, with due regard for factors such as certainty of computation of transition costs, maximization of proceeds, fairness, efficiency and rapidity, and impact upon the competitive market. Two fundamental divestiture strategies were considered:

- Asset sale through auction
- Asset sale through negotiated private transaction

Q. WHAT IS AN ASSET SALE THROUGH AUCTION?

A. An asset sale through auction is a method of divestiture that uses a staged bidding process and allows numerous potential purchasers to participate. In general, an auction is the method that will most likely reveal the market value of an asset because it tends to draw out the largest number of potential buyers.

In light of existing uncertainties regarding the operation of the new electricity market, different potential buyers may have widely varying views of future electricity prices and the development of a direct access market. This may lead to a wide range of values attributed to the generation assets by potential purchasers. It is therefore desirable to expand the pool of potential buyers, at least initially, in order to identify buyers who value the assets most highly. By identifying and soliciting buyers who value the assets most highly, TEP will maximize the proceeds received from a sale and minimize stranded costs.

In addition to maximizing price, an auction advances other objectives, such as fairness to ratepayers, shareholders, and potential buyers. Further, an auction provides greater likelihood of convincingly demonstrating to the Commission and to other interested parties the market value of these stations.

Q. WHAT IS AN ASSET SALE THROUGH NEGOTIATED PRIVATE TRANSACTION?

A. In an asset sale through a negotiated private transaction, TEP would contact a limited number of parties for each asset and attempt to negotiate a sale through those contacts. In some contexts, a negotiated sale with one or possibly a few potential buyers may be the only realistic alternative. This may be true, for example, where there are significant restrictions on

the seller's ability to dispose of an asset, or where market circumstances are such that it is highly unlikely that more than one party would even be potentially interested in purchasing the asset. Because fewer potential buyers are involved in a negotiated sale compared to an auction, sometimes the process is easier to manage.

Q. WHAT ARE THE RELATIVE MERITS OF AN AUCTION AND A NEGOTIATED SALE?

A. So long as TEP believes that a pool of buyers exist to purchase its generating assets, the primary advantage of a negotiated sale is the manageability of the process. However, a carefully designed auction process need not preclude incorporating the more beneficial aspects of negotiation. The auction should draw out the largest number of potentially qualified and interested parties thereby ensuring the best sale price. To make the process most efficient, TEP will narrow the field of bidders based on the bidders' preliminary bid submittals. This narrowing will enable TEP to deal with a more manageable number of parties as time-intensive activities, such as on-site due diligence and discussion of contractual language, proceed. An important feature of a staged auction is that it enables multiple rounds of bidding, providing flexibility to respond to bidders' concerns as well as incentivizing bidders to increase their offers. If TEP, as the seller, is prohibited from engaging in such activities as part of the auction, this lack of flexibility might deter potential bidders from participating, and TEP might be prevented from selling the generating assets at the best price and other terms. Based upon these considerations, TEP believes that the auction process should retain considerable flexibility.

Q. WHY WAS THE AUCTION METHOD CHOSEN?

A. Both an auction sale and a negotiated sale are reasonable and justifiable methods of disposing of generating assets. NHI recommends TEP proceed with an auction sale because it is more likely to give TEP and the Commission the greatest measure of assurance regarding the consequences of the divestiture, to ensure the best price for the assets, to attract and satisfy the largest number of potential owners, and is the most consistent with the regulatory process.

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Q. IS THE TRANSCO PROPOSAL WITH ARIZONA PUBLIC SERVICE ("APS") A VIABLE METHOD FOR REALIZING FAIR MARKET VALUE FOR TEP'S SHARE IN THE NAVAJO AND FOUR CORNERS GENERATING STATIONS?

A. As I have discussed previously, a negotiated sale is a viable means of realizing the fair market value of generating assets. The Transco proposal between TEP and APS has some unique aspects, which make a negotiated sale a particularly appropriate method of divestiture for the Navajo and Four Corners assets. The transmission assets of APS are an integral part of TEP's plans to become the builder and owner of transmission assets in Arizona, and cannot be obtained from a broad market solicitation of bids. Also, divesting the generating assets and acquiring transmission assets in separate transactions would be a more time consuming process than having both parties agree to the Transco proposal at this time.

III. How Will the Auction Process Work?

Q. WHAT ARE THE GOALS OF THE AUCTION?

A. TEP, in consultation with NHI, has designed its auction procedures with a focus on the goals of efficiency and price maximization, as well as fairness to all interested parties. In order to expedite divestiture, TEP has developed a streamlined, staged approach that is intended to ensure a fair auction process while preserving sufficient flexibility to allow for the maximum possible competition among potential and actual bidders for the assets that are to be sold.

Q. WHAT IS THE PROPOSED SCHEDULE FOR THE AUCTION?

A. Although TEP must retain the flexibility to alter its schedule to reflect unanticipated events, an anticipated schedule has been established to auction TEP's generating assets. The Company plans to implement a five-phase auction process, which is summarized in the following timetable (all dates are estimates only):

Phase 1	Pre-auction marketing activities Preparation of selling memorandum Preparation of assets for sale Buyer prequalification	through March 1999
Phase 2	Distribution of selling memorandum Receipt and analysis of indications of interest	April through June 1999

	Selection of short list of bidders	
Phase 3	Due diligence for short list participants	July through September 1999
	Receipt of final bids	
	Selection of winning bidders	
Phase 4	Negotiation and Execution of Documents	October through November 1999
Phase 5	Final regulatory approvals	By January 1, 2001
	Closing	

The timetable set forth above is tentative, and assumes among other things, timely regulatory approvals and the removal of material asset contingencies.

Q. WHAT IS THE COMMISSION'S ROLE DURING THE AUCTION PROCESS?

A. The Commission will be kept informed during every phase. The auction has been designed to be as robust and transparent as possible. While the bids must be kept confidential to ensure the integrity of the auction, TEP and NHI believe that the Commission must be informed of the progress of the auction.

Q. WHAT IS EXPECTED TO TAKE PLACE AT EACH STAGE OF THE AUCTION PROCESS?

A. The auction process has been designed to ensure that all bidders have the same opportunity to evaluate and bid on the generating assets. Phase 1 of the process is ongoing and will continue during the Commission's review period for this filing up until the commencement of the actual auction (Phase 2). Phase 1 activities include gathering all of the information necessary for bidders to conduct their due diligence, which will include operating, financial, environmental, legal and technical information on the generating assets. During Phase 1, NHI will assist TEP in identifying and contacting potential purchasers. TEP will also prepare a press release directing bidders to contact New Harbor in order to be included in the process. Phase 2 is the stage where initial indications of interest are provided by bidders. Potential bidders will receive copies of the Confidentiality and Auction Protocol Agreements as well as be given or have access to due diligence materials. Following the initial review period in Phase 2, bidders will be asked to submit non-binding Indications of Interest. TEP with NHI will evaluate the Indications of Interest and select a "short list" of bidders to invite into Phase 3, to conduct more extensive due diligence on the assets. The Indications of Interest will be

evaluated primarily on price, financing contingencies, financial wherewithal to complete the transaction and any necessary consents or approvals that could significantly delay a closing. Specific bidders will be invited to participate in Phase 3 and will be provided additional due diligence material, site tours, and management presentations in order to make final bids for the assets. Phase 3 will require a high level of resources and commitment from the invited bidders. At the end of Phase 3, the bidders will be required to submit their final bids. Upon receipt of the final bids by NHI and TEP, the auction will enter Phase 4 where the final bids will be evaluated on a similar basis to the Indications of Interest and winning bidders will be selected. Bidders will be required to be available to meet with TEP and NHI for final negotiations and contract execution. Phase 4 will conclude with documents executed between the winning bidders and TEP for the generating assets. In Phase 5, the last phase of the auction process, TEP will submit executed documents to the Commission for approval. The Commission will have the opportunity at this time to review the filings to satisfy itself that the auctions were done in a fair, diligent and professional manner. Any other regulatory approvals, such as FERC and the Federal Trade Commission, will be obtained in this last phase.

Q. WHAT HAPPENS AT THE CONCLUSION OF THE AUCTION?

A. The auction will actually be concluded at the end of Phase 4 when the winning bidders have executed documents for the purchase of the generating assets. At that time, Commission and regulatory approvals of the sales will be obtained. Furthermore, upon completion of the auction process, but prior to the actual sale and transfer of the assets, TEP will file appropriate form of transfer documents and proposed must-run contracts for approval by the Commission.

IV. What Are the Auction Protocols?

Q. WHAT IS THE PURPOSE OF THE AUCTION PROTOCOLS?

A. TEP and NHI have designed an auction process to attract a wide universe of qualified bidders which will result in a market determination of the value of the generation assets in a manner that is fair to the bidders, efficient in terms of time requirements and effective for TEP, its shareholders and ratepayers. The auction protocols provide potential bidders with the details of the auction process including: the auction methodology, tentative timetable, rules of

conduct, bidding restrictions, methods of allowable communication, cost responsibility and the form of bid. The auction protocols will be contained in the Confidentiality and Protocols Agreement, which each potential bidder will be required to execute prior to participating in the auction process.

Q. WHAT IS INCLUDED IN THE CONFIDENTIALITY AND PROTOCOLS AGREEMENT?

A. In addition, to containing the auction protocols, the Confidentiality and Protocols Agreement will obligate the potential bidder, its affiliates and representatives to maintain as confidential, any information, documents, data or any other material provided by TEP ("Due Diligence Material") or analyses performed by the bidder. Any such Due Diligence Material and analyses may be used by the bidder solely for the purpose of evaluating the assets. Potential bidders will be required to treat as confidential any bid or related discussions it has with TEP. Destruction of Due Diligence Material shall be certified by an officer of the bidder. Due Diligence Material provided to participants in the auction will include, among other things, a selling memorandum, any third-party environmental or engineering reviews performed for TEP in conjunction with the auction, as well as environmental, operating and technical information and data. Such information may be made available in a data room or provided directly to the potential bidder.

Q. WHEN WILL THE CONFIDENTIALITY AND PROTOCOL AGREEMENT BE DISTRIBUTED?

A. The Confidentiality and Protocol Agreement will be distributed to potential bidders at the end of Phase 1. No potential bidder will receive a Selling Memorandum on which to base initial indications of interest until the Confidentiality and Protocol Agreement has been signed and returned to TEP.

V. What Are the Current Divestiture Plans of TEP?

Q. WHICH ASSETS ARE BEING DIVESTED?

A. Bidders will have an opportunity to bid on any or all of the following Assets:[1]

[1] TEP has entered into the Settlement Agreement with the Commission Staff which will exchange TEP's interest in the Four Corners and Navajo generating stations for the transmission assets of the Arizona Public Service Company.

(i) Springerville (100% interest)

(ii) Irvington (100% interest)

(iii) San Juan (TEP's 50% interest in each of Units 1 and 2); and

(iv) TEP's combustion turbines

TEP reserves the right to bundle, or to change the bundling of the assets. Bidders will be notified of any changes and appropriate adjustments will be made to the auction timetable, if necessary, to allow for a resubmission of bids reflecting revised bundling, or for any other reason.

The Assets will include Leasehold, as well as ownership interests. The divestiture will include all ancillary agreements, operating permits, real and personal property, inventory and spare parts required to operate the Assets. TEP will retain ownership of and reserve any necessary easements for transmission facilities and associated property and lines from the facilities. In addition, because TEP will retain its transmission and distribution operations, the Company may enter into one or more joint use/management agreements with the purchasers of the Assets relating to systems or facilities necessary for the operations of each party.

Q. WHAT TEP CONTRACTS MAY BE ASSIGNED?

A. The divestiture of Assets will require the assignment or modification of several ancillary agreements. The most significant of those agreements are the coal and transportation agreements relating to Springerville and Irvington, and the project agreements relating to TEP's interests in remote generating facilities operated by other utilities.

Q. WILL TEP BE ALLOWED TO BID ON ANY ASSETS?

A. The auction process has been designed to provide all bidders access to the same information and due diligence materials regarding the generating assets. Should a TEP affiliate decide to bid on any or all of the Assets, appropriate "fire walls" will be established between the bidding affiliate and TEP personnel involved in the auction. The bidding affiliate will be required to enter into the Confidentiality and Auction Protocols Agreements modified to permit the affiliate to communicate only with NHI. The affiliate will have access to the same information and will be required to adhere to the same rules and standards of conduct as all the other bidders. Indications of interest and final bids from the affiliate will be delivered to

NHI as an independent third party, be opened first and evaluated with the other bids prior to disclosure to TEP.

VI. What Is the Current Market for Generating Assets?

Q. WHY HAVE OTHER UTILITIES CHOSEN AN AUCTION SALE?

A. As stated earlier, the most viable options considered for divestiture of utility assets are an auction sale or a negotiated sale. Each has its advantages and disadvantages. NHI recently completed the sale of generating assets for Southern California Edison ("SCE") through an auction process. The reasons SCE chose to do an auction are similar to the reasons that NHI has recommended TEP proceed with an auction: provide the greatest measure of assurance regarding the consequences of divestiture, ensure the best price for the assets, to attract the largest number of potential bidders, and to avoid unnecessary delay. NHI is currently conducting an auction for the 1340 MW Centralia Generating Station, in the State of Washington, for these same reasons.

Q. WHAT ARE SOME OF THE OTHER UTILITY AUCTIONS THAT HAVE BEEN ANNOUNCED?

A. Across the country, the electric utility market is undergoing substantial and fundamental changes. Many states, like Arizona, are strongly encouraging their traditionally integrated electric utilities to separate into non-regulated generating companies and regulated transmission and distribution companies. Most utilities have chosen to date to sell their soon to be non-regulated businesses including generation, and used or plan to use an auction process in almost every case. Fifteen utilities, including TEP, have announced intentions to divest some or all of their generation assets. The total megawatts for sale are approximately 38,000 MW of which 15,000 MW is coal. The two utilities with announced impending auction sales nearest TEP are Nevada Power and PG&E (California). Exhibit A lists the announced, but not completed, utility generation divestiture activity in the U.S.

Q. WHAT IS THE LIKELIHOOD OF A SUCCESSFUL AUCTION BY TEP?

A. Over the past two years, the market has been robust for domestic generating assets. Approximately 15 utilities have sold mostly gas-fired generating assets for prices from less than one to over five times book value. The five coal-fired facility sales included in the above group yielded proceeds in the range of one to over three times book value. A list of

the generating assets that have been sold in the past two years is provided in Exhibit B. There is currently little generation sale activity in the Southwest. That lack of activity should make potential bidders interested in the auction, and the prices recently obtained for generation assets have been attractive. Accordingly, we believe there is a high likelihood the auction process proposed by TEP will result in the realization of the maximum value for its generating assets.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

Exhibit A

List of Recently Announced Utility Auctions

Seller	Timing	Fuel Type(s)	Total Capacity (MW)	Coal Capacity (MW)
Central Hudson	By Q2.01	Coal, Gas, Oil	972	366
Con Edison	By Q1.99	Gas, Oil	3,665	0
Duquesne	Early 1999	Coal, Nuclear, Oil	3,035	2,138
ENOVA	By Q4.98	Gas, Oil, Nuclear	1,897	0
Nevada Power/ Sierra Pacific Resources	NA	Coal, Gas, Oil, Hydro	2,725	1,343
NIMO	By Q4.98	Coal, Gas, Oil, Hydro	4,217	1,300
Northeast Utilities	By Q4.98	Coal, Gas, Oil, Hydro	3,482	NA
Orange & Rockland	By Q2.99	Coal, Gas, Oil, Hydro	984	460
PacifiCorp (Centralia)	By Q4.98	Coal	1,340	1,340
PG&E	1998	Gas, Oil, Geothermal	4,289	0
Plains Electric G&T Cooperative	1999	Coal, Gas	278	250
Portland General Electric	By 1998	Coal, Gas, Oil, Hydro	3,363	712
Unicom (CWE)	By Q3.99	Coal	5,576	5,576
Unisource (Tucson Electric)	By Q1.01	Coal, Gas	1,992	1,182
Western Massachusetts Electric	By Q1.99	Oil, Gas, Hydro	290	209
			38,150	14,876

Exhibit B

List of Recently Completed Utility Auctions

(Dollars in millions, except price per kW)

Date Ann.	Buyer	Seller	Plant	Type	Net MW	Total Price	Book Value	Price/kW	Price to Book
11/09/98	Sithe Energies	GPU	23 power plants and 18 generation development properties	Various	4,117	$1,680	$791	$408	2.12
11/09/98	FirstEnergy	GPU	20% interest in Seneca hydroelectric generating station	Hydro	87	43	11	494	3.98
11/02/98	PP&L Global	Montana Power	11 Hydroelectric plants, 2 Coal-fired plants	Hydro, Coal	1,556	988	637	635	1.55
11/02/98	PP&L Global	Puget Sound/Portland General	1058-MW interest in Montana Power's 4-unit Colstrip Plant	Coal-fired	1,058	598	464	565	1.29
10/15/98	NRG	Eastern Utilities Associates	Somerset Station (160 MW)	Various	160	55	31	344	1.80
10/02/98	Wisconsin Energy	United Illuminating	Bridgeport Station Harbor Station (590 MW oil & coal), New Haven Harbor Station (466 MW oil & gas)	Various	1,056	272	218	258	1.25
09/28/98	PP&L Global	Bangor Hydro-Electric Company	8 hydro units, and Wyman Unit 4 (52 MW share)	Hydro, Oil	89	89	49	998	1.80
08/03/98	AES Corporation	NYSEG Generation	Kintigh Station (675 MW), Milliken Station (300 MW), Greenidge Station (160 MW), Goudey Station (125 MW), Hickling Station (70 MW), and Jennison Station (70 MW).	Coal-fired	1,400	950	886	679	1.07
08/03/98	Edison Mission	GPU & NYSEG	1,884-MW Homer City Electric Generation Plant	Coal-fired	1,884	1,800	540	955	3.33
07/07/98	WPS Resources	Maine Public Service	Wyman Unit 4 (20.7 MW share), several small diesel and hydro plants.	Various	91.8	37	12	406	3.20
05/27/98	Southern Energy Inc.	Commonwealth Energy System	Canal Unit 1, Canal Unit 2 (50% interest), five diesel generators, Kendall Station, Kendall Jets, 1.4% interst in Wyman Unit 4	Various	984	462	79	470	5.85

03/25/98	Houston Industries	Southern California Edison	(1)	Ormond Beach	Gas-fired	1,500	40	141	27	0.28
02/04/98	NRG/Destec	Southern California Edison	(1)	Long Beach	Gas-fired	530	30	98	56	0.30
01/06/98	FPL Group	Central Maine Power		91 hydro units (373 MW), 31 MW of wood capacity and 781 MW of fossil-fueld (3 plants)	Various	1,185	846	240	714	3.53
12/10/97	Sithe Energies	Boston Edison		Mystic, New Boston, L Street, Edgar Framingham, West Medway, Wyman	Oil & Gas	1,987	536	450	270	1.19
11/24/97	AES	Southern California Edison	(1)	Alamitos, Huntington Beach, Redondo	Gas-fired	3,956	781	228	197	3.42
11/24/97	Houston Industries	Southern California Edison	(1)	Coolwater, Mandalay, Ellwood, Etiwanda	Gas-fired	2,276	237	127	104	1.87
11/24/97	NRG/Destec	Southern California Edison	(1)	El Segundo	Gas-fired	1,020	88	71	86	1.23
11/24/97	Thermo Ecotek	Southern California Edison	(1)	San Bernardino and Highgrove	Gas-fired	280	10	-6	34	NM
11/18/97	Duke Energy	PG&E		Morro Bay, Moss Landing, and Oakland	Gas-fired	2,645	501	380	189	1.32
08/07/97	US Generating	NEES		3 thermal plants, 15 hydro-electric 23 power purchase contracts	Various	5,100	1,590	1,100	312	1.45
10/31/96	Allegheny Power	Duquesne Light & Power		Fort Martin (50% interest of unit one)	Coal-fired	276	170	45	616	3.78