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NEW APPLICATION

BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
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Commissioner

DOCKET NO. E-01933A-98-0471

DOCKET NO. ~~E-01703A-98-0469~~

IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY AND FOR RELATED APPROVALS, AUTHORIZATIONS AND WAIVERS.	DOCKET NO. ________________ **NOTICE OF FILING**

Pursuant to Decision No. 60977 and A.A.C. R14-2-1607.D, Tucson Electric Power Company hereby files its Application for Approval of its Plan for Stranded Cost Recovery and for Related Approvals, Authorizations and Waivers.

RESPECTFULLY SUBMITTED this 21st day of August, 1998.

TUCSON ELECTRIC POWER COMPANY

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IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY AND FOR RELATED APPROVALS, AUTHORIZATIONS AND WAIVERS.	) DOCKET NO. ______________)) APPLICATION)))

DOCKET NO. E-01933A-98-0471

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner - Chairman
RENZ D. JENNINGS
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Commissioner

IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY AND FOR RELATED APPROVALS, AUTHORIZATIONS AND WAIVERS.	DOCKET NO. ________________ **APPLICATION**

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Tucson Electric Power Company ("TEP" or the "Company") applies to the Arizona Corporation Commission (the "Commission"), pursuant to A.R.S. §§ 40-203, 40-251, 40-285, 40-301 and 40-302; A.A.C. R14-2-1607 and R14-2-804; and Commission Decision No. 60977 dated June 22, 1998, for an order approving the Company's Stranded Cost recovery plan as set forth herein and for related approvals, authorizations and waivers.[1] In support hereof, the Company states as follows:

I. INTRODUCTION AND BACKGROUND

A. The Applicant

TEP is a wholly owned subsidiary of UniSource Energy Corporation ("UniSource"), organized and existing under the laws of the State of Arizona with its principal office and place of business in the City of Tucson, Arizona. TEP owns and operates facilities for the generation, purchase, transmission, distribution and sale of electricity within the City of Tucson, to the surrounding Pima County area and to Fort Huachuca in Cochise County. In addition, TEP owns interests in property in Arizona and New Mexico in connection with the generation and transmission of electric power. TEP is a public service corporation as defined in Article 15, § 2 of the Arizona Constitution and has been granted a Certificate of Public Convenience and Necessity ("CC&N") by the Commission to be the exclusive provider of electric service within its service territory pursuant to A.R.S. § 40-281.

B. Retail Electric Competition and Stranded Cost Recovery

On December 26, 1996, the Commission adopted Retail Electric Competition Rules A.A.C. R14-2-1601, *et seq.* ("Rules" or "Competition Rules") to introduce retail electric competition in Arizona.[2] The Rules provide for a phase-in transition to a competitive electric

[1] This Application is submitted subject to, and without waiver of, any claim, cause of action or request for relief set forth in any TEP or other appeal of the Commission's Competition Rules and any order or decision issued in connection therewith.
[2] The Rules were subsequently amended by the Commission on August 10 1998 in Decision No. 61071.

generation market commencing on January 1, 1999 with full implementation on January 1, 2001. Because the market value of generating assets is estimated to be lower than the regulated cost of such assets, the transition from a cost-based regulated environment to a competitive market will result in "stranded costs" to TEP. A.A.C. R14-2-1607.B provides that "the Commission shall allow a reasonable opportunity for recovery of unmitigated Stranded Costs by Affected Utilities." A.A.C. R14-2-1601.39 defines "Stranded Costs" to include:

a. The verifiable net difference between: i) the value of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchase power contracts, fuel contracts, and regulatory assets), acquired or entered into prior to the adoption of this Article, under traditional regulation of the Affected Utilities; and ii) the market value of those assets and obligations directly attributable to the introduction of competition under this Article;

b. Reasonable costs necessarily incurred by an Affected Utility to effectuate divestiture of its generation assets;

c. Reasonable employee severance and retraining costs necessitated by electric competition, where not otherwise provided; and

On June 22, 1998, the Commission issued Decision No. 60977 (the "Decision"), which provides, among other things, a choice of two methods for utilities to recover Stranded Costs. Option No. 1 - Divestiture/Auction Methodology - provides for a determination of the amount of Stranded Costs by divesting and auctioning off all generation assets. Under that option, Affected Utilities are permitted to recover 100 percent of Stranded Costs, including a return on the unamortized balance, over a period of 10 years. Option No. 2 - Transition Revenues Methodology - provides for recovery of revenues sufficient to maintain financial integrity, such as avoiding default under existing financial instruments, for a period of 10 years, after which there would be no further Stranded Cost recovery. The Decision requires Affected Utilities to file a preliminary election of either option, together with an implementation plan by August 21 and a final election by October 1, 1998.

C. Election of Divestiture for Stranded Cost Recovery

If the Company is to maintain its financial viability and position itself to compete effectively in a competitive market, it must recover all of its Stranded Costs. The Company has reviewed both options for Stranded Cost recovery and has determined that only divestiture provides an opportunity for full recovery. That option provides the benefits of competition to the Company's customers, while providing fair compensation and return to its stakeholders. In addition, the Company agrees that separation of generation from regulated assets will promote a robust competitive market. Divestiture will also result in a true market valuation of the Company's generating assets, facilitating an accurate determination of Stranded Costs. Accordingly, this Application sets forth the Company's final plan of divestiture and Stranded Cost recovery pursuant to the Decision and A.A.C. R14-2-1607.[3] Divestiture of the Company's generating assets will be a complicated process. In order for divestiture to be a viable means for the Company to fully recover its Stranded Costs, the following must be addressed in the Commission's order granting TEP's Application:

1. The Company's Financial Structure

A substantial portion of the Company's generating assets are subject to leveraged leases. The leased assets are assignable but only with continuing recourse to the Company. Also, the leases can be terminated but only under very limited circumstances and any termination would require a cash payment to the lease participants equal to contracted stipulated loss value less any proceeds from selling the leased assets. In addition, to avoid an event of loss under the lease, the debt associated with the Company's leveraged lease of the Common Facilities relating to its Springerville Generating Station must be refinanced prior to January 1, 2000. Generating

3 Although the Order requires a final plan of divestiture be filed with the Commission for approval by October 1, 1998, the Company has elected to file its final plan at this time. Supplemental filings will be made for approval of transfer documents, must-run contracts and other divestiture requirements referenced herein.

assets owned by TEP are subject to the lien of the Company's Mortgage Indentures, and a release of the lien will need to be obtained at the time the assets are sold. The Company will not have a sufficient amount of unused collateral under its Mortgage Indentures to issue the amount of secured debt necessary to pre-pay the debt and obligations associated with the divested assets and, consequently, a means of financing the divestiture payments will be required. A low cost alternative for such financing is securitized bonds. Securitized bonds would require the Company have the ability to securitize its stream of Stranded Costs revenues. Finally, the Company's Bank Credit Agreement contains financial covenants that must be maintained following divestiture, and operating covenants that, among other things, limit the amount of assets that the Company can sell.

2. Pre-Divestiture Transition Revenues

The Decision requires divestiture to be completed before January 1, 2001. The retail electric market will begin to open on January 1, 1999. As a result, the Company is likely to incur Stranded Costs for the period prior to divestiture. An interim transition charge will be required to permit the Company to recover pre-divestiture Stranded Costs.

3. Alternative Recovery

As the Decision indicates, the market for generating assets in the Southwestern United States is uncertain, due to over-capacity in the region. In addition, many other jurisdictions have required utilities to divest generating assets in connection with retail competition proceedings. As a result, the auction may result in no acceptable bids. In such case, the Company must have a definitive alternative mechanism that provides full recovery of Stranded Costs.

4. Current Commission Rules and Orders Affecting TEP

In Decision No. 60480, dated November 25, 1997, the Commission authorized the Company to form a holding company. In that Decision, the Commission imposed 28 operating and financial conditions on the Company, many of which are inconsistent with the Rules, or place the Company at a disadvantage relative to its competitors. In addition, a number of other Commission Rules and Orders that did not anticipate for the advent of retail electric competition remain in effect with regard to the Company. Each should be modified or waived if the Company is to be afforded the opportunity to compete on a level playing field.

Each of the foregoing factors is discussed in detail in this Application.

D. Conditions to Divestiture

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 factors discussed in the preceding Section C must be addressed sufficiently. Accordingly, as a condition to TEP's election to divest generating assets, the Company will require from the Commission an order that provides, among other things, the following:

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

b. An interim mechanism for recovery of Stranded Costs relating to the period between the implementation of retail electric competition and completion of divestiture;

c. 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;

d. A definitive mechanism for full recovery of Stranded Costs determined through divestiture, and an alternative mechanism for full recovery in the event the Company is unable to successfully divest, in either case supported by findings and orders sufficient to allow the securitization of the revenue stream associated with Stranded Cost recovery;

e. Authorization under the Commission's Affiliated Interest Rules to form a special purpose entity necessary for securitization; and

f. Modification or waiver of those Commission rules and orders which reduce the Company's ability to compete effectively in the retail electric market.

For the Company to complete the auction process before January 1, 2001, it will be necessary to have a final order from the Commission as expeditiously as possible. A proposed form of order is attached hereto as Exhibit A.

II. DESCRIPTION OF ASSETS TO BE DIVESTED

The Company intends to divest all of its generating assets and associated property (the "Assets"). The Assets include the following generating resources:

Generating Source	Unit No.	Location	Fuel Type	Net Capability MW	Operating Agent	TEP's Share %	TEP's Share MW
Springerville Station	1	Springerville, AZ	Coal	380	TEP	100.0	380
Springerville Station	2	Springerville, AZ	Coal	380	TEP	100.0	380
San Juan Station	1	Farmington, NM	Coal	316	PNM	50.0	158
San Juan Station	2	Farmington, NM	Coal	312	PNM	50.0	156
Navajo Station	1	Page, AZ	Coal	750	SRP	7.5	56
Navajo Station	2	Page, AZ	Coal	750	SRP	7.5	56
Navajo Station	3	Page, AZ	Coal	750	SRP	7.5	56
Four Corners Station	4	Farmington, NM	Coal	784	APS	7.0	55
Four Corners Station	5	Farmington, NM	Coal	784	APS	7.0	55
Irvington Station	1	Tucson, AZ	Gas/Oil	81	TEP	100.0	81
Irvington Station	2	Tucson, AZ	Gas/Oil	81	TEP	100.0	81
Irvington Station	3	Tucson, AZ	Gas/Oil	104	TEP	100.0	104
Irvington Station	4	Tucson, AZ	Coal/Gas/Oil	156	TEP	100.0	156
Combustion Turbines	1-5	Tucson AZ	Gas/Oil	121	TEP	100.0	121
TOTAL Company Capacity							1,895

As discussed in Section IV, the Assets 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. The transfer documents for each plant will set forth in detail the real and personal property to be conveyed. The Company will retain ownership of and reserve any necessary easements for transmission facilities and associated property and lines from the facilities. In addition, because the Company 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 (e.g. water wells). The following is a summary description of the generating Assets:

A. Springerville Generating Station

The Springerville Generating Station ("Springerville") is located in Springerville, Arizona and consists of two 380 MW coal-fired units, situated on approximately 22 square miles of plant property. Springerville is operated by TEP. Unit 1 was placed in commercial operation in 1985 and Unit 2 in 1990. A sale-leaseback for all of Unit 1, which included both the specific plant and its portion of common facilities (facilities shared with Unit 2), was completed in 1986, *See IV. FINANCIAL STRUCTURE, A. Leveraged Leases.* The Unit 2 specific plant is owned by San Carlos Resources, Inc. ("San Carlos"), a wholly owned subsidiary of TEP and the Unit 2 common facilities are leased by San Carlos. The fuel handling facilities at Springerville, which provide coal to both units, are also leased by TEP.

B. Irvington Generating Station

The Irvington Generating Station ("Irvington") is a four unit generating station located in Tucson, Arizona on approximately 200 acres of land. Irvington is operated by the Company. The units were placed in commercial operation on the following dates: Unit 1 - 1958, Unit 2 - 1960, Unit 3 - 1962 and Unit 4 - 1967. Units 1, 2 and 3 are gas or oil burning generating units and the generating capacity ratings are 81 MW, 81 MW and 104 MW, respectively. During 1982-1987, the Company modified Unit 4 to burn coal in addition to oil or gas as fuel. Unit 4 has a capacity rating of 156 MW burning gas or oil and a capacity rating of 110 MW burning coal. In January 1988, the Company completed a sale and leaseback arrangement for Unit 4, *See IV. FINANCIAL STRUCTURE, A. Leveraged Leases.*

C. Remote Facilities

1. Navajo Generating Station

The Company owns a 7.5% interest in each of the three 750 MW units at the Navajo Generating Station ("Navajo") located in Page, Arizona on land leased from the Navajo Tribe of Indians. That percentage interest equates to a generating capacity of 56 MW from each unit, or 168 MW in total. The other participants in Navajo are Arizona Public Service Company ("APS"), Department of Water and Power of the City of Los Angeles, Nevada Power Company, Salt River Project ("SRP") and the United States of America Bureau of Reclamation and Western Area Power Administration. SRP is the operating agent. Units 1, 2 and 3 were brought on-line in 1974, 1975, and 1976, respectively.

2. Four Corners Generating Station

The Four Corners Generating Station ("Four Corners") is a five unit coal-fired generating station located near Farmington, New Mexico on land leased from the Navajo Tribe of Indians. TEP owns a 7.0% interest in each of the 784 MW Units 4 and 5, providing the Company a generating capacity of 55 MW from each unit, or 110 MW in total. Units 4 and 5 were placed into commercial operation in 1969 and 1970. Four Corners is a mine mouth plant; thus no fuel transportation is required. In addition to the Company, the participants in Four Corners are APS, El Paso Electric Company, Public Service Company of New Mexico ("PNM"), SRP and Southern California Edison Company. APS is the operating agent of the station.

3. San Juan Generating Station

The San Juan Generating Station ("San Juan") is a four unit coal-fired generating station located near Farmington, New Mexico on approximately 3,000 acres of land. The

Company owns 50% interests in each of Units 1 and 2 providing to the Company generating capacity of 158 MW and 156 MW, respectively, or 314 MW in total. The units were put into operation in 1976 and 1973. The proximity of the mine to the station negates the need for any long-haul transportation agreement. There is an agreement with the San Juan Transportation Company, for coal transportation over a distance of approximately 20 miles. The parties to the San Juan project agreements are the Company and PNM. PNM is the operating agent of the station.

D. Combustion Turbines

The Company owns five Westinghouse 251B combustion turbines which are located in Tucson, Arizona. The units' individual generating capacities range from 23-25 MW and the total generating capacity of the five units is 121 MW. All of the turbines began commercial operation in 1972 and can be fueled with either gas or oil.

III. ANCILLARY CONTRACTS

Divestiture of the 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 the Company's interests in remote generating facilities operated by other utilities.

Coal is supplied to Springerville under a Coal Sales Agreement ("CSA") between TEP and Peabody Coal Sales. The CSA is a requirements contract and runs through 2010. Coal is transported by rail from the mine to Springerville under a transportation agreement between the Company and Burlington Northern and Santa Fe ("BNSF") which expires December 31, 2009.

Coal is supplied to Irvington under a Coal Supply Agreement between TEP and The Pittsburgh & Midway Coal Mining Co. The contract has a term through 2015 or the useful life of Irvington, whichever is earlier, but termination may not occur earlier than 2006. Coal is transported to the station by BNSF and Union Pacific Southern Pacific. The transportation agreement expires on December 31, 2015 or upon the expiration of the useful life of Unit 4, whichever is earlier. In conjunction with the divestiture of Irvington and Springerville, the Company will need to negotiate assignments of the coal and rail transportation agreements without recourse to the Company. Divestiture of the Company's interests in the remote facilities (Navajo, Four Corners and San Juan) will require assignment by the Company of various project agreements relating to each facility. The project agreements contain advance notice requirements and provide rights of first refusal to the other participants, at the greater of fair market value or the offer price.

The Company also leases rotary gondola rail cars from Residual Based Finance Corporation under a financing lease. The lease runs through 2006. The rail cars are used to transport coal to Irvington and Springerville. The lease is not assignable without the Lessor's consent, and any assignment does not relieve the Company from ultimate liability. Accordingly, the Company will be required to negotiate an assignment of the lease without recourse to the Company.

IV. TEP'S FINANCING STRUCTURE AND DIVESTITURE CONSIDERATIONS

The provisions of the Company's financing arrangements must be considered and addressed in connection with the divestiture of the Assets. The most significant are the Company's leveraged leases, tax-exempt local furnishing bonds, mortgage indentures, and Bank Credit Agreement. The following is a brief overview of each:

A. Leveraged Leases

The Company or its subsidiary, San Carlos, is the lessee under separate leveraged lease arrangements relating to: i) Irvington Unit 4; ii) an undivided one-half interest in the common facilities at Springerville; (iii) the coal handling facilities serving Springerville; and (iv)

Springerville Unit 1 and an undivided one-half interest in the common facilities at Springerville. Each of the leases is a financing arrangement pursuant to which the underlying asset was sold to third parties and leased to the Company or San Carlos. The sale of the assets was funded by owner participants and debt participants in each lease. A more complete description of the leases is set forth in Schedule 1 to this Application.

The Company has no option to terminate the leveraged lease arrangements prior to the end of the lease term. However, under certain specified circumstances, summarized in Schedule 1, the leases may be terminated prior to the end of the lease term. Generally, in cases of such early termination, the Company would be obligated to pay the stipulated loss value ("Stip Loss") set forth in the lease (a predetermined contractual amount) together with any unpaid rent and the premium, if any, payable on the lease debt less the sale price of the asset. If each of the leases terminated and the Company was obligated to pay stipulated loss values as of January 1, 2001, such payments would total approximately $1.2 billion prior to any reduction based on the sales price of the assets.

The lease relating to the undivided interests in the common facilities related to Unit 2 at Springerville provide that an event of loss will occur if the debt underlying such lease is not refinanced by January 1, 2000. The Company would be required to pay the higher of fair market value or Stip Loss of approximately $144 million upon such event of loss. The Company may use such an event as a method of terminating such lease. If such an event of loss would occur prior to the time when divestiture would otherwise be completed, the Company may seek a financing order from the Commission to either (i) issue securities to provide bridge financing to pay the amounts due under the lease for such event of loss or (ii) permit the Company to cause the existing lease indebtedness to be refinanced.

Each of the leases provides that the Company may not, without the prior written consent of the lease participants, sublease or assign any of its rights or interest in the lease or otherwise permit the leased asset to be operated by any other person. Consent may not be unreasonably withheld by the lease participants in the case of a sublease to a third party having senior secured debt rated at least BBB+ by S&P and Baa1 by Moody's. No such assignment or sublease will relieve the Company of any of its obligations under the leases, without first obtaining negotiated consent of all lease participants (debt and equity).

B. Two-County Bonds

A substantial portion of the Assets qualifies for tax-exempt financing as "facilities for the local furnishing of electric energy" within the meaning of the Internal Revenue Code. TEP in its various loan agreements has agreed to do nothing that would adversely affect the tax-exempt status of interest on the "two-county bonds." Should the Company's local furnishing system become disqualified, in whole or in part, due to Asset divestiture, it likely would be necessary for some or all of these bonds to be redeemed or defeased. The Company has approximately $580 million of two-county bonds outstanding.

The total amount of "two-county bonds" issued for the benefit of TEP is divided between ten series; each series finances specific facilities. Springerville Unit 2 is financed as a two-county facility by four bond series totaling $250 million. A portion of the Irvington station is also financed with $39 million of "two-county bonds." An additional $91 million of two-county bonds are outstanding under the Unit 4 lease.

To maintain the tax-exempt status of "two-county bonds," the Company must continue to operate as a two-county utility, meaning its existing retail franchise must be limited to two counties, and each asset financed with "two-county bonds" must be used *solely* to serve its two-county franchise customers except during emergencies.

TEP meets these guidelines by:

a. keeping its service territory within Pima and Cochise counties;

b. maintaining only inbound power flows into TEP's two-county local T&D system except during emergencies; and

c. operating in such a manner that, except during emergencies, power from "two-county bond" financed generating facilities (Irvington & Springerville Unit 2) flow only into the local T&D system.

In general, non-compliance with either of the first two conditions would eliminate tax-exempt, two-county financing and force the Company to redeem all "two-county bonds." Maintaining the first two conditions but breaking the third condition may require the redemption of only the debt related to the specific two-county financed asset which ceases to qualify.

Selling Springerville Unit 2 and/or the Irvington station, as the divestiture contemplates, would cause the Company to violate the third condition. The first two conditions are expected to be maintained which should allow the Company to retain tax-exempt, two-county financing for its other facilities such as local T&D but force the redemption of certain tax-exempt "two-county bonds" that financed Springerville and Irvington. Springerville Unit 2 is currently a two-county asset, but upon the sale, it is expected the asset will no longer to be used solely to serve the two-county service territory. The sale of Springerville Unit 2 and Irvington in such a fashion is a "nonqualifying change in use" under IRS regulations and could cause the interest on the "two-county bonds" to be taxable retroactive to the date on which the bonds were issued unless the Company qualifies to take appropriate "remedial action." In general, the requirements of these IRS regulations will be met if:

a. on the date the bonds were issued (or reissued) the Company reasonably expected all the output from the facility would be used solely for consumption by retail customers within the Company's two-county service area for the entire term of the bond issue;

b. the output from the facility in fact has been used solely for consumption by retail customers within the Company's two-county service area since the date on which the bonds were issued (or reissued);

c. the buyer pays fair market value for the facilities; and

d. the portion of "two-county bonds" which financed the facility are redeemed at the earliest call date after the date on which output from the facilities is no longer used solely for consumption by retail customers within the Company's two-county service area; if outstanding bonds are not redeemable within 90 days, a yield restricted escrow account must be established to provide for redemption of the bonds at their earliest call date

TEP expects that it would meet all these requirements provided sufficient asset sale proceeds and/or proceeds from a Stranded Costs "securitization" transaction are available to redeem the affected tax-exempt "two-county bonds."

C. Mortgage Indentures

The utility plant Assets owned by the Company are subject to the lien of an Indenture dated as of April 1, 1941 to the Chase Manhattan Bank, trustee (the "1941 Mortgage"), and an Indenture of Mortgage and Deed of Trust dated as of December 1, 1992 to Bank of Montreal Trust Company, trustee (the "1992 Mortgage"). Springerville Unit 2 is not subject to the lien of either Indenture because title is held by San Carlos, not TEP.

To sell utility plant Assets without a continuing Indenture lien, the Company can obtain a lien release by meeting conditions specified by the respective Indenture. To release Assets from the 1941 Mortgage, the Company can deliver to the Trustee (among other things), cash having an aggregate fair market value equal to the fair value of the property to be released. The release provision of the 1992 Mortgage is similar. The Company may also release property from the 1992 Mortgage by delivering to the 1992 Mortgage Trustee a copy of a release from the 1941 Mortgage and an affirmation that the proceeds received for the property are held by the 1941 Mortgage Trustee and will be paid over to the 1992 Mortgage Trustee in the event the Company becomes entitled to withdraw the proceeds under the terms of the 1941 Mortgage. To complete the divestiture of its Assets, the Company may be required to i) retire tax-exempt, two-county debt, *See IV Financing Structure and Approvals Required, B. Two-County Bonds;* ii) make payments to lease participants or assignees of the leases, *See IV Financing Structure and Approvals Required, A. Leveraged Leases;* and iii) retire other debt associated with the assets sold. The total of the foregoing payments are likely to exceed the sale proceeds received for the Assets. Accordingly, it will be necessary for the Company to obtain a release of the proceeds of the sale of Assets subject to the lien of the 1941 and 1992 Indentures from the 1941 and 1992 Mortgage Trustees. Such proceeds can be withdrawn by the Company under the 1941 Mortgage by certifying "property additions" or in an amount equal to previously retired first mortgage bonds ("retired bond credits"), *See Schedule 2, The 1941 Mortgage, Withdrawal of Cash.* Proceeds may also be withdrawn under the 1992 Mortgage by certifying "property additions" or based on previously retired first or second mortgage bonds, *See Schedule 2, The 1992 Mortgage, Withdrawal of Cash.* The Company believes it will have sufficient property additions and retired first and second mortgage bond credits to release the Asset sale proceeds from the 1941 and 1992 Mortgages. A more complete description of the Company's Mortgage Indentures is set forth in Schedule 2.

D. Credit Agreement

In December 1997, TEP entered into a $544 million Bank Credit Agreement (the "Credit Agreement"), consisting of a $100 million Revolving Credit Facility for general corporate purposes and a $444 million Letter of Credit Facility to support $428.6 million aggregate principal amount of tax-exempt variable rate debt obligations (collectively, the "Facilities"). The Letter of Credit Facility was reduced to $341 million in May 1998. The Credit Agreement is collateralized by Second Mortgage Bonds.

Under the Credit Agreement, the Company is required to maintain certain financial covenants including (a) a minimum Consolidated Tangible Net Worth equal to the sum of $133 million plus 40% of cumulative Consolidated Net Income since January 1, 1997, (b) a minimum Cash Coverage Ratio ranging from 1.30 in 1997 and gradually increasing to 1.55 in 2002, and (c) a maximum Leverage Ratio ranging from 7.0 in 1997 and gradually decreasing to 6.2 in 2002. The divestiture of the Assets must preserve the ability of the Company to maintain compliance with those financial covenants. In addition, under the Credit Agreement, the Company is prohibited from selling property, businesses or assets with an aggregate fair value in excess of $350 million. That value limitation increases on a dollar-for-dollar basis by the aggregate amount of each reduction of the Facilities (and Second Mortgage Bonds).

The Company believes in connection with the divestiture, it will reduce the Facilities of the Credit Agreement and retire sufficient Second Mortgage Bonds to meet the sales of assets limitation in the Credit Agreement, provided the Company is able to conclude the securitization transaction described in this Application. Nevertheless, to complete the divestiture and securitization, the Company may be required to negotiate an amendment to or waiver of various covenants of the Credit Agreement.

V. DIVESTITURE TRANSACTIONS AND ALTERNATIVES

To determine the best method of divesting the Assets, TEP considered the need for a process that would: i) permit the divestiture to take place in a timely manner; ii) encourage participation by a broad range of potential purchasers; and iii) establish the value of the Assets through a true market determination, thereby maximizing the value received by the Company. The Company believes those objectives will best be achieved through an auction process. As indicated in Schedule 3 to this Application, there is currently an active market for generating assets. Marketing the Assets to a broad universe of potential purchasers in a competitive bidding situation is more likely to result in higher sales prices and a more accurate determination of the market value of the Assets. Recent sales of non-nuclear generating assets by utilities in states requiring some form of divestiture have been conducted through an auction process. The announced results of such sales are included in Schedule 3.

As more fully set forth in Section VI of this Application, potential purchasers will have the option of bidding on any or all of the Assets. This will allow bidders to consider and account for possible efficiencies from owning groups of generating assets. This flexibility should result in a higher aggregate purchase price.

While an auction process will be used to sell the Assets, the type of transaction disposing of the Assets may vary, depending upon, among other things, the nature of the Company's interest in such Assets. Assets owned outright by the Company will be transferred pursuant to a Asset Purchase Agreement. Assets leased by the Company may be transferred by an Assignment or other appropriate instrument. Forms of agreements necessary to transfer the Assets will be submitted to the Commission for approval in a supplemental filing.

As discussed previously, a substantial portion of the Assets are in the form of leveraged leases, *See IV. The Company's Financing Structure and Divestiture Considerations, A. Leveraged Leases, and Schedule 1.* The leases are assignable only with continued recourse to the Company, and are terminable only under certain limited circumstances. The Company's preferred alternative for disposition of its leasehold assets is to negotiate a termination of the leases, and auction the underlying assets for the benefit of the owner participants. Any difference between the cost of terminating the leases and the proceeds received for the underlying Assets would be included in the Company's Stranded Costs.

Should the Company be unable to negotiate satisfactory terms for termination of the leases, an alternative is to divest the leasehold interests and assign the leases without recourse to the Company. In this case, any payments, together with additional costs of assigning the leases without recourse would be included in the Company's Stranded Costs.

Terminating the leases will result in a more streamlined auction and increase the number of potential purchasers. The complexity, consents and multiple party negotiations required to assign the leases may reduce the pool of potential bidders and make it more difficult for the Company to eliminate its obligations under the leases following divestiture. Potential bidders may also be concerned with the terms of the leases, including strict financial and operating covenants. Limiting the pool of potential purchasers for the leased assets may also reduce the number of potential buyers for the owned assets with respect to Springerville and Irvington.

Proposed forms of Purchase and Sale Agreement, Assignment and other operative transfer documents will be filed for approval by the Commission prior to distribution of such documents to potential bidders on the Assets.

VI. PROPOSED AUCTION PROCESS

The Company has designed its proposed auction process in conjunction with New Harbor Incorporated ("New Harbor"), the Company's financial advisor. New Harbor has substantial experience in the sale of generating assets, having represented Southern California Edison in the sale of its fossil fuel plants pursuant to the California electric industry restructuring. The auction process is designed to attract a wide universe of qualified bidders resulting in a market determination of the value of the Assets.

A. Procedures and Protocols

The Company's proposed auction process entails five phases, which are summarized in the following timetable.

Phase	Activity	Timing
1.	- Pre-auction Marketing Activities - Preparation of Selling Memorandum - Preparation of Assets for Sale - Buyer Prequalification	Through December 31, 1998
2.	-Distribution of Selling Memorandum - Receipt and Analysis of Indications of Interest - Selection of Short List of Bidders	January through March, 1999
3.	- Due Diligence for Short List Participants - Receipt of Final Bids - Selection of Winning Bidders	April through June, 1999
4.	- Negotiation and Execution of Documents	June, 1999
5.	- Final Regulatory Approvals - Closings	By January 1, 2001

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

The Company will reserve the right to reject any and all bids for an Asset if deemed unacceptable as determined in the Company's sole discretion. In addition, the Company will retain the ability to amend the auction procedures and protocols or suspend or terminate the auction, should it be in the best interest of the Company and its stakeholders. Prospective bidders will be required to execute a Confidentiality and Protocols Agreement prior to their participation in the process.

A more detailed discussion of the Company's proposed auction process and protocols is set forth in Exhibit B of this Application.

B. Affiliate Bidding Procedure

The proposed auction process has been designed to provide all bidders access to the same information and due diligence materials regarding the Assets. Should an affiliate of the Company decide to bid on any or all of the Assets, appropriate "fire walls" will be established between the bidding affiliate and Company personnel involved in the auction. The bidding affiliate will be required to enter into the Confidentiality and Protocols Agreement modified to permit the affiliate to communicate only with New Harbor. The affiliate would have access to the same information and would be required to adhere to the same rules and standards of conduct as all other bidders. Indications of interest and final bids from the affiliate will be delivered to an independent third party, be opened first and evaluated with the other bids.

VII. ESTIMATE OF UNMITIGATED STRANDED COSTS

Pursuant to A.A.C. R14-2-1607(H), the Company has attached its estimate of unmitigated Stranded Costs as Schedule 3 to this Application. Schedule 3 sets forth categories of Recoverable Stranded Costs and a range of estimates of the amount of such costs. The schedule also includes analyses and data relating to market transactions for generating assets. The Schedule will be supplied under the terms of a Confidentiality Agreement between the Company and participants in this proceeding and represents the Company's estimate of Stranded Costs via the divestiture option.

The range the Company anticipates given the assumptions used, is between $600 million and $1.1 billion. This estimate includes but is not limited to the net gain/loss on owned assets, payments to assign/terminate leases, generation related regulatory assets, sales tax assessments, coal contract termination fees, environmental remediation expenses, employee related costs, and transaction and other divestiture-related costs. The analysis is based on numerous assumptions, and actual Stranded Costs will vary. In this Application, the Company is seeking a final approval of its proposed *methodology* for determination and recovery of Stranded Costs. The actual *amount* of such costs will be determined only upon completion of the divestiture process.

VIII. STRANDED COST RECOVERY

The Company proposes two separate cost mechanisms to recover generation costs that are above market values in a competitive environment. An interim competition charge ("ICTC") is proposed for the pre-divestiture transition period and a competitive transition charge ("CTC") for the post-divestiture period.

A. Step One: Interim Competition Transition Charge

As competition will be phased in for certain customers beginning January 1, 1999, it is necessary for the Company to establish a collection mechanism to recover above market-generation costs prior to the implementation of the CTC. TEP proposes to implement an ICTC. A complete description of the ICTC is set forth in Exhibit C, "Interim Competition Transition Charge Tariff." The tariff explains the accounting and rate-making treatment of the ICTC mechanism.

The ICTC will be in effect until such time as the CTC is implemented and will be charged to competitive customers and to Standard Offer customers as a component of the Standard Offer Rate. The ICTC will be the difference between the Standard Offer embedded cost of generation under traditional ratemaking and a market price for power. The market price of power will be based on the Dow Jones Palo Verde Index[4] ("PVI"). The Company proposes that the ICTC be estimated by quarter based on forward power market prices at Palo Verde

[4] The Dow Jones Palo Verde Index is a measure of actual spot market prices. Dow Jones collects volume and price data from the majority of entities who transact physical power at Palo Verde Switchyard. The transaction data relates to daily and hourly trades only, it does not include monthly or longer transactions executed in the OTC or NYMEX markets. The Palo Verde Index also excludes any transactions at Palo Verde scheduled to the California ISO.

utilizing the NYMEX Palo Verde Index[5] ("NYMEX") and trued up based on actual power costs as measured by the PVI. A fuel and purchased power adjustment mechanism is proposed to ensure recovery of the proper level of ICTC. The difference between the embedded generation costs in the Standard Offer of each rate schedule and the market price for generation (NYMEX) applicable to each rate schedule (i.e. adjusted for capacity factor) is the ICTC component. TEP will determine the ICTC component of the Standard Offer by rate schedule quarterly.

If the difference between the forecasted and actual PVI price for the quarter is within a stated band, TEP will adjust the second quarter ICTC by the amount of over or under collection. If the difference between the forecasted and actual PVI price for the quarter is outside the stated band, TEP will seek Commission approval to adjust the second quarter for the first quarter over or under recovery.

Any balance will be added or subtracted from the amount of Stranded Costs that will give rise to the CTC.

B. Step Two: Competition Transition Charge

Upon the completion of the divestiture of the Company's generating assets, all of the Company's unrecovered Stranded Costs will be reflected on the Company's books and records as a Regulatory Asset ("Stranded Cost Recovery Asset"), under FAS 71. Pursuant to the Decision, to the extent the final sale price of any Asset exceeds the Company's net book value for such Asset, 50 percent of the gain on such Asset will be applied to reduce the Company's Stranded Costs. A CTC will be put into effect when approved by the Commission based on the "Competition Transition Charge and Transition Component Tariff" provided in Exhibit D. The tariff explains the accounting and rate-making treatment of the CTC mechanism.

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[5] Electricity futures contracts are traded publicly at the New York Mercantile Exchange ("NYMEX"). Palo Verde Switchyard futures contracts are traded in 2 MW blocks for monthly on and off-peak periods for 18 forward months. A futures contract is an agreement between a buyer and seller for delivery of a particular quantity of a commodity at a specific time, place and price. The price of the futures contract reflects the current market consensus of commodity price expectations in the future.

TEP proposes to collect the CTC through a cents per kWh, a kW and/or a fixed fee charge from all customers. Rate Schedule responsibility for the CTC will be based on the last approved retail cost of service study. The Company will also attempt to securitize a substantial portion of this amount in order to minimize the carrying costs of the CTC. *See Section X - Securitization of CTC.*

The Commission will approve the level of Stranded Costs to be collected and the establishment of an initial CTC that will be adjusted accordingly over the term of the defined collection period.

C. Exit Fees

TEP proposes a moratorium on Exit Fees during the transition period until divestiture is complete. Divestiture will quantify the proper level of Stranded Costs and the resulting total Stranded Cost balance from customers via the CTC. A moratorium on Exit Fees helps ensure that TEP will not under or over-collect the CTC from customers. Upon divestiture and final determination of the CTC to be collected through ACC hearings, exit fees can be instituted with much more certainty. See Exhibit D for a description of the Company's Exit Fee calculation.

D. Failed Auction

In the event the auction of one or more generating units is unsuccessful, TEP will file Stranded Costs estimates on those unit(s). Stranded Costs estimates will be based on the "Net Revenues Lost" methodology and will be filed within 90 days of the failed auction. The "Net Revenues Lost" approach is a top-down quantification method that compares the expected future annual revenue requirements of the unit that did not sell under traditional cost-based regulation with the annual revenues expected to be recovered in a competitive generation market with prices based on marginal cost. The approach recognizes that utilities that made investment decisions under the traditional regulatory paradigm expected a revenue stream from customers to cover the cost of such investments over their useful lives. Under the Net Revenues Lost methodology, Stranded Costs are measured as the net present value of the annual differences between the expected revenues under a continuation of regulation and those likely to be received after the introduction of retail competition.

IX. PROPOSED ACCOUNTING AND RATEMAKING TREATMENT

Upon the completion of the divestiture of the Company's generating assets, all of the Company's unrecovered Stranded Costs will be reflected on the Company's books and records as Regulatory Asset ("Stranded Cost Recovery Asset") under FAS 71. For the purpose of FAS 71, the final determination of Stranded Cost recovery needs to ensure that the following are provided:

a. Regulated cash flows to recover 100% of Stranded Cost Regulatory Asset. Until the divestiture is completed, the regulated cash flows will be sufficient to recover the book value of plant and regulatory assets and a return so that no write-offs under FAS 71 or 121 result. After divestiture, regulated cash flows will be sufficient to recover 100% of Stranded Cost Regulatory Asset and a return thereon;

b. Cash flows to recover Stranded Costs will come from regulated revenues, rather than competitive revenues. The regulated cash flows will come from rates charged directly as a tariffed rate, or as an ICTC or CTC or through proceeds from securitized bonds which will be paid off through regulated revenues;

c. An automatic adjustment mechanism will be implemented to provide a high level of assurance that Stranded Costs will be recovered over a period ending no later than December 31, 2008, and

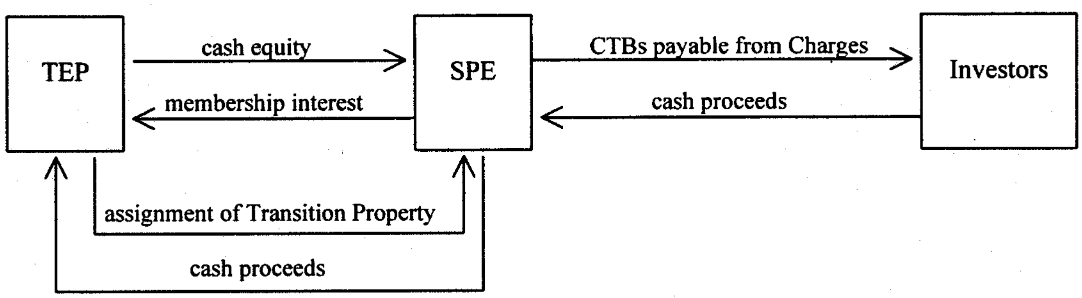
d. Stranded Cost Regulatory Asset recovery will include a debt and an equity return.

X. SECURITIZATION OF CTC

In order to complete divestiture of both owned and leased generating assets, TEP expects to be required to make substantial cash payments to various creditors, lease participants and other parties. TEP seeks to finance that cash requirement through a "securitization" of the charges, as described below. TEP believes that such a "securitization" transaction will result in lower rates during the transition period than any other form of financing.

A. Proposed Transaction Structure

It is proposed that the needed cash be raised through debt instruments (Competition Transition Bonds or "CTBs") issued by a bankruptcy remote subsidiary of TEP (the "Special Purpose Entity" or "SPE").[6] Principal and interest on the CTBs will be payable only from revenues and assets of the SPE, consisting primarily of the right to be paid the full amount of the Company's Stranded Costs, plus interest on the unpaid balance. This right is referred to as the "Transition Property." Schematically, the proposed transaction would be structured as follows:



In order to provide for the payment of the Transition Property, the Company proposes to establish a separate, non-bypassable and irrevocable rate (the "Charges") on a per kWh basis, or a per meter basis, or a combination of both, applied uniformly to all sales of electricity within TEP's historic service area utilizing TEP's distribution system. One method of applying the "Charges" will be to establish a CTC applicable to Customers who provide electricity other than from the Company. The other will be to include a separate rate element ("TC") in the Company's Standard Offer. The CTC and the TC will be the same for all customers in the same class.

An automatic adjustment would be approved pursuant to which the Charges are adjusted periodically (at least annually) to the extent the total amount actually collected pursuant to the

6 A.A.C. R14-2-804 requires TEP to obtain Commission authorization to obtain an financial interest in, or use utility funds to form, an affiliate. Accordingly, the Company requests Commission authorization to form the SPE.

Charges varies from the amount required to pay scheduled principal and interest on the CTBs, associated expenses, and a modest "overcollateralization amount" (probably about 0.5% of total scheduled principal payments).

B. Credit Rating Issues

The transaction must be structured to ensure that the CTBs receive the highest possible rating from at least two national credit rating agencies, and that credit ratings of TEP's debt and equity securities are not adversely affected. This will ensure the lowest possible financing cost to TEP and to its customers. The rating agencies' credit analysis will focus on whether the transaction isolates the Transition Property from TEP's credit risks, and on the credit quality of Transition Property. Ratings will be based on several factors including: i) the opinion of counsel regarding the treatment in a bankruptcy of TEP of the transfer of Transition Property from TEP to the SPE; ii) credit enhancement; iii) the analysis of TEP's ability to forecast energy usage and the credit risks associated with its retail customers; iv) risks associated with currently unknown third party servicers collecting a portion of the Charges; v) legislative, regulatory and voter initiative risks associated with the transaction; vi) the automatic adjustment mechanism; and (vii) whether the changes will continue even if TEP ceases to own or operate its local T&D facilities.

TEP must be able to establish that the transfer of the Transition Property from TEP to the SPE constitutes a "true sale" for bankruptcy purposes, and that TEP and the SPE will not be substantively consolidated for bankruptcy purposes. The "true sale" between TEP and the SPE must provide the rating agencies assurance that Transition Property will be unavailable to satisfy TEP's creditors in the event of a TEP bankruptcy. Instead, this revenue stream must be able to continue to be collected for the SPE and be pledged to pay debt service on the CTBs.

The Commission must approve the structure of the transaction so that a satisfactory "true sale" will have occurred. Among other things, the "true-sale" structure will require the following: i) a line item on the utility bill to provide notice that customer bill amounts attributable to the Charges are separate and distinct from the revenues of TEP; ii) TEP, acting as servicer of Transition Property on behalf of the SPE, must be paid a servicing fee which represents a fair market price for these services (the fee must be adequate to attract a substitute servicer in the event TEP fails to perform satisfactorily as servicer); and (iii) consistent with the SPE's ownership of Transition Property, customers must have the legal right to pay the SPE directly, and the SPE must have the corresponding legal right to sue customers for nonpayment of the Charges.

The automatic adjustment mechanism must allow TEP to adjust the Charges to account for variations in actual collections from those originally forecast. For example, such variations may arise from deficiencies due to reductions in usage from projections, failures of customers to pay amounts owed, and any failure of TEP or third-party servicers to remit the full amount of their collections. The design, frequency and ensured regulatory implementation of an automatic adjustment mechanism will be critical to rating agencies as they evaluate the reliability and adequacy of payments. The more frequent and timely true-ups are, the less additional credit enhancement the rating agencies will require to rate the CTBs at the highest possible rating, thus ensuring the lowest cost to customers.

Additional credit enhancement is expected in the form of "overcollateralization" to ensure that investors will receive timely payment of all principal and interest due them by requiring the CTBs to be secured by Transition Property, the value of which exceeds the total principal amount of the CTBs. The amount of overcollateralization will be determined by the rating agencies, based on the amount of principal and interest which otherwise would remain unpaid on the scheduled maturity date under the rating agencies' worst case scenario. Any overcollateralization that is collected as part of the Transition Property, in excess of total debt service, will be the property of the SPE.

In order to determine the amount of required credit enhancement, the rating agencies also will analyze TEP's ability to forecast energy usage by looking at historic data on forecasted and actual usage. The rating agencies are expected to apply a wide range of assumptions on uncollectibles and energy usage and the effectiveness of the automatic adjustment mechanism to assess how vulnerable revenues from the Charges will be to changes in assumptions. This analysis is important, and the authorized frequency and prompt implementation of the automatic adjustment mechanism will be critical in reassuring the rating agencies that CTB debt service will be paid as scheduled without requiring substantial overcollateralization.

The rating agencies also will likely consider regulatory, legislative, and voter initiative risks, including the risk that the Commission's order could be altered, overturned or abolished in the future. Since the CTBs are without recourse to the Company and only payable from funds provided from the Charges, it is critical from an investor perspective that the Charges should not be reduced in a manner which would impair timely payments of debt service on the CTBs.

C. Tax Issues

TEP expects that the transfer of Transition Property to the SPE and the issuance of CTBs will not cause the current recognition of federal taxable income for the following reasons: i) the transfer of Transition Property to the SPE has no federal income tax consequences because the SPE will be treated as a division of TEP for income tax purposes; ii) the SPE's issuance of CTBs will be treated as secured debt of TEP for federal tax purposes; and iii) no income associated with the Charges will be realized by TEP until electricity is provided to TEP's distribution customers paying the Charges. The IRS has confirmed these results in private letter rulings issued to Pacific Gas & Electric, Southern California Edison and San Diego Gas & Electric Company in connection with their 1997 securitization transactions. TEP will seek an IRS ruling confirming these results in connection with the CTBs.

D. Accounting Issues

The CTBs will be recorded as debt on TEP's consolidated balance sheet. However, this is not expected to have an adverse impact on the credit rating of TEP since the CTBs will be non-recourse to TEP. TEP will add a footnote to its financial statements disclosing that the CTBs are secured solely by Transition Property and other assets of the SPE, that CTB investors have no recourse to any assets or revenues of TEP, that TEP and its creditors have no direct claim to the Transition Property, and that the SPE is legally separate from TEP.

E. Servicing Issues

TEP will act as servicer for the Transition Property. TEP or an energy service provider ("ESP") will be responsible for reading customer meters and billing and collecting the Charges. On behalf of the SPE, TEP or the ESP is expected to remit Charges periodically to a trustee who will be responsible for making periodic debt service payments to CTB investors and paying other ongoing costs associated with the transaction. The Charges will be set at a level that allows the SPE to recover the full amount of Transition Property. TEP also will be responsible for filing an advice letter periodically with the ACC to adjust the Charge, to the extent that actual debt service payments vary from scheduled debt service payments, and to reflect revised annual usage forecasts.

So long as TEP's short-term credit rating is below "A-1," "P-1," and "F-1," the rating agencies are expected to require remittances to the trustee within two days of receipt to avoid an adverse impact on the CTBs' credit rating.

Amounts collected that represent partial payments of a customer's bill will be allocated between the trustee and TEP based on the ratio of the portion of the billed amount allocated for the Charges to the total billed amount. This allocation is an important bankruptcy consideration in determining the "true-sale" nature of the transaction.

The trustee will retain all collections of the Charge until the trustee (i) makes scheduled principal and interest payments and all servicing fees and ongoing expense payments to the appropriate parties; and (ii) pays the authorized equity return to SPE. These distributions are expected to be made on a quarterly or semi-annual basis. Between the remittance date and distribution date, the trustee will hold all collections of the Charge received from TEP in a collection account. The trustee will invest the funds in the collection account in investment grade short-term securities which mature on or before the next distribution date. Interest earned by the trustee on investments in the collection account is expected to be held as a reserve fund for the payment of future interest on or (at maturity) principal of the CTBs due to collection shortfalls.

F. CTB Characteristics

The CTBs are expected to be issued by the SPE in the form of notes with multiple expected final maturities ranging from three months to eight years and legal final maturities ranging from three months to eight years to allow for delays in scheduled principal payments. The structure and maturity dates will be determined at the time the CTBs are priced, to result in the lowest debt cost while reaching a wide investor base. Interest rates will be fixed or floating as determined at the time of issuance to provide the lowest all-in cost to ratepayers and to maximize the chance that TEP will recover all unmitigated Stranded Costs. Any floating rate exposure may be mitigated with swaps or other interest rate risk management instruments.

An amortization schedule for the CTBs will be determined in consultation with rating agencies.

Each CTB note will be priced based on its average life, determined by the projected principal amortization schedule at the time of issuance. It is expected that each CTB note will be priced at a basis point spread over United States Treasury Notes with a comparable average life.

XI. WAIVER OF COMMISSION RULES AND ORDERS

A. Waiver of Conditions in Holding Company Order

As noted previously, in Decision No. 60480, dated November 25, 1997, the Commission authorized the Company to form a holding company. In that decision, the Commission imposed 28 operating and financial conditions on the Company, many of which are inconsistent with the Competition Rules, or place the Company at a disadvantage to its competitors. Schedule 6 sets forth those conditions for which the Company hereby requests a waiver.

B. Other Waivers

Additionally, there are a number of other Commission rules and orders, set forth in Schedule 6, to which the Company is subject, that are inconsistent with a competitive retail electric market and/or inappropriate in light of TEP's Plan. The Company is also requesting a waiver of those rules and orders.

XII. AFFILIATE REQUIREMENTS

Because Arizona is not establishing a power exchange similar to the California model the Commission must ensure that a generation affiliate of a UDC cannot provide services to a marketing affiliate on more favorable terms than any other market entrant. Accordingly, TEP requests that the Commission establish a mechanism in this docket or the CC&N docket which prohibits the generation affiliate of a UDC from offering generation services to a marketing affiliate on more favorable terms than would otherwise be available to unaffiliated marketers.

Unaffiliated marketers should have access to generation and generation services from the generation affiliate of a UDC on the same basis as the UDC's affiliates. Such provisions are necessary in order to provide a transparent market. TEP proposes a minimum monthly reporting requirement for all affiliate transactions.

XIII. SYSTEM RELIABILITY

Under the Commissions competition rules, control area operators for the UDCs which must open their service territories are required to act as independent system operators ("ISOs") to facilitate the reliable delivery of power from new competitors to customers that opt for competitive access. As a result, the respective UDC control area operators are required to provide open access for any required ancillary services that a competitive supplier requests. Further, as the responsible party to the local and national reliability councils (WSCC and NERC), the control area operator is ultimately responsible for any penalties that may be incurred if its control area standards are not maintained at required levels and thus has the responsibility to ensure that third party suppliers are fully accounting for all services required to meet reliability requirements.

TEP does not believe that it has identified all of the services that must be offered and therefore tariffed with the FERC, the Commission, or both. The only such services for which the Company currently has FERC authority are the six services associated with its open access transmission tariff. In comparison, the California ISO has 47 separate services which it offers to ensure that the control area responsibilities of the competitive markets in California are met. Services for which the Company does not currently have tariff authority, include must-run generation, distribution losses and schedule imbalance services. TEP is currently working to develop a complete list of services and associated tariffs.

Additionally, the Company will require contracts for the purchase of certain ancillary services (e. g. must-run generation) with purchasers of certain Assets to meet ongoing reliability requirements. This will require that contract requirements and terms, including pricing, are disclosed to potential purchasers of these Assets prior to the auction. As a result, the Company will require approval and agreement regarding terms, pricing, etc., from the Commission and the FERC prior to the initiation of the auction.

The Company proposes that all ancillary services it believes are required to begin competitive access and for which contracts will be offered to those bidding on associated Assets be filed with the Commission and the FERC prior to October 31, 1998.

XIV. OTHER NECESSARY APPROVALS AND WAIVERS

A. Federal Energy Regulatory Commission

Section 203 of the *Federal Power Act* and 18 C.F.R.§ 33.1, require that a public utility obtain an order from the FERC prior to selling its facilities subject to the jurisdiction of FERC. The Company will need such an order to divest of the assets covered by this Plan. The Company's ability to divest of the assets covered by this Plan is subject to FERC's issuance of an order approving such divestiture.

B. Shareholder Approval

The Company may seek UniSource shareholder approval of the implementation of the Stranded Cost recovery plan set forth in this Application.

C. Hart-Scott-Rodino Filing

Each sale for $15 million or more will require the filing of a notification with the U.S. Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

XV. POST-DIVESTITURE FILINGS

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. In addition, the Company will file a rate case to determine its regulated rates and charges on a going forward basis as a Utility Distribution Company ("UDC"). It is anticipated that the rate case will be approved by the Commission prior to the sale and transfer of the assets so that the securitization can reflect the level of Stranded Costs and the adjustments to the CTC.

XVI. COMMUNICATIONS

The name, mailing address, E-mail address, telephone number and fax number of the person upon whom service of all pleadings, motions and other documentation is to be made is:

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Tucson Electric Power Company
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XVII. CONCLUSION

The Stranded Cost recovery plan presented in this Application provides TEP a reasonable opportunity to recover its Stranded Costs while recognizing the Company's unique financial and business circumstances. Approval of the plan is consistent with the Decision and the Competition Rules, and is in the public interest.

* * * * * * * * * * * *

WHEREFORE, Tucson Electric Power Company requests the Commission to issue an Order approving its Stranded Cost recovery plan and all other requested approvals, authorizations and waivers as set forth in this Application.

RESPECTFULLY SUBMITTED this 21st day of August, 1998.

TUCSON ELECTRIC POWER COMPANY

By: ______________________

Dennis R. Nelson
Vice President, Secretary and
General Counsel

Exhibit A

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 PLAN FOR STRANDED COST RECOVERY AND FOR RELATED APPROVALS, AUTHORIZATIONS AND WAIVERS.	DOCKET NO. ________________ DECISION NO. ______________ **ORDER**

Open Meeting
________, 1998
Tucson, Arizona

FINDINGS OF FACT

1. Tucson Electric Power Company ("TEP" or "Company") is an Arizona corporation engaged in providing electric service to the public within portions of Pima and Cochise Counties, pursuant to Certificates of Convenience and Necessity ("CC&Ns") granted by the Arizona Corporation Commission ("Commission").

2. TEP is an Affected Utility within the meaning of A.A.C. R14-2-1601, *et seq.* ("Competition Rules")

3. On June 22, 1998, the Commission issued Decision No. 60977 ("Decision") regarding stranded cost recovery by Affected Utilities.

4. The Decision provides Affected Utilities with two options for stranded cost recovery: i) the Divestiture/Auction Methodology ("Option 1"); and ii) the Transition Revenues Methodology ("Option 2").

5. A.A.C. R14-2-1607 and the Decision require Affected Utilities to file, for Commission approval, their choice of options and an implementation plan for stranded cost recovery by August 21, 1998.

. . .

6. On August 21, 1998, TEP filed with the Commission an application: i) electing Option 1; ii) setting forth its plan for stranded cost recovery; and iii) requesting related approvals, authorizations and waivers (the "Application").

7. The assets proposed to be divested by TEP (the "Assets") are set forth in the Application, and include the following generating resources:

Generating Source	Unit No.	Location	Fuel Type	Net Capability MW	Operating Agent	TEP's Share %	TEP's Share MW
Springerville Station	1	Springerville, AZ	Coal	380	TEP	100.0	380
Springerville Station	2	Springerville, AZ	Coal	380	TEP	100.0	380
San Juan Station	1	Farmington, NM	Coal	316	PNM	50.0	158
San Juan Station	2	Farmington, NM	Coal	312	PNM	50.0	156
Navajo Station	1	Page, AZ	Coal	750	SRP	7.5	56
Navajo Station	2	Page, AZ	Coal	750	SRP	7.5	56
Navajo Station	3	Page, AZ	Coal	750	SRP	7.5	56
Four Corners Station	4	Farmington, NM	Coal	784	APS	7.0	55
Four Corners Station	5	Farmington, NM	Coal	784	APS	7.0	55
Irvington Station	1	Tucson, AZ	Gas/Oil	81	TEP	100.0	81
Irvington Station	2	Tucson, AZ	Gas/Oil	81	TEP	100.0	81
Irvington Station	3	Tucson, AZ	Gas/Oil	104	TEP	100.0	104
Irvington Station	4	Tucson, AZ	Coal/ Gas/Oil	156	TEP	100.0	156
Combustion Turbines	1-5	Tucson, AZ	Gas/Oil	121	TEP	100.0	121
TOTAL Company Capacity							1,895

8. The Company or its subsidiary, San Carlos, is the lessee under leveraged lease arrangements relating to: i) Irvington Unit 4; ii) an undivided one-half interest in the common facilities relating to Springerville; iii) the coal handling facilities serving Springerville; and . . .

iv) Springerville Unit 1 and an undivided one-half interest in the common facilities relating to Springerville.

9. Approximately $580 million of TEP's Assets has been financed by bonds, substantially all the proceeds of which financed "facilities for the local furnishing of electric energy" within the meaning Section 142 of the Internal Revenue Code of 1986 ("two-county bonds").

10. The interest on the two-county bonds is, generally, excluded from gross income for federal income tax purposes.

11. Should the Company's local furnishing system become disqualified as "facilities for the local furnishing of electric energy" in whole or in part, due to related asset divestitures as contemplated by the Company, it is likely TEP would have to arrange for the redemption or defeasance of some or all of the two-county bonds.

12. The cost of redemption or defeasance of the two-county bonds (including the higher cost of capital associated with securities issued to fund the redemption or defeasance) is a recoverable Stranded Cost.

13. The utility plant Assets of TEP are subject to the liens of the following indentures: i) Indenture, dated as of April 1, 1941, from TEP to the Chase Manhattan Bank, trustee, as amended and supplemented ("1941 Indenture"); and ii) Indenture of Mortgage and Deed of Trust, dated as of December 1, 1992, from TEP to Bank of Montreal Trust Company, trustee, as amended and supplemented ("1992 Indenture").

14. The auction process proposed by TEP in Exhibit B of its Application ("TEP auction process") will establish an accurate determination of the market value of the Assets.

15. Upon the completion of the divestiture of the Assets, all of the Company's Stranded Costs will be reflected on the Company's books and records as a Regulatory Asset under FAS 71.

16. The Company has proposed two separate mechanisms to recover Stranded Costs: an Interim Competition Charge ("ICTC") for the pre-divestiture transition period; and a Competitive Transition Charge ("CTC") for the post-transition period.

17. The ICTC will be in effect from January 1, 1999 until the earlier of the date of divestiture of all of TEP's Assets and obligations associated therewith or the date on which CTB's are issued for the benefit of TEP (the "Transition Period").

. . .

18. The Company proposed that the ICTC be estimated by quarter based on forward power market prices at Palo Verde utilizing the NYMEX Palo Verde Index ("NYMEX") and trued up based on actual power costs as measured by the Palo Verde Index ("PVI"). A fuel and purchased power adjustment mechanism will ensure recovery of the proper level of ICTC.

19. The use of PVI as a proxy for the market price of generation is reasonable.

20. TEP will determine the ICTC component of the Standard Offer by rate schedule quarterly.

21. If the difference between the forecasted and actual PVI price for the quarter is within a stated band, TEP will adjust the second quarter ICTC by the amount of over or under collection. If the difference between the forecasted and actual PVI price for the quarter is outside the stated band, TEP will seek Commission approval to adjust the second quarter for the first quarter over or under recovery.

22. It is in the public interest that the ICTC be charged to TEP's competitive service customers and to TEP's Standard Offer customers as a component of the Standard Offer rate.

23. It is in the public interest that a CTC (and a TC, as defined below) be put into effect in substantially the form provided in Exhibit D to the Application.

24. TEP has proposed to collect the CTC through a cents per kWh, a kW and/or a fixed fee charge from all customers.

25. TEP has proposed a moratorium on Exit Fees during the Transition Period.

26. A moratorium on Exit Fees will help ensure that TEP will not under or over-collect the CTC from customers after the Transition Period.

27. In the event that the auction of one or more generating unit is unsuccessful, TEP has proposed to determine Stranded Cost estimates of those unit(s) based on the "Net Revenues Lost" methodology described in the Decision and will file that determination within 90 days of the failed auction. Upon completion of the auction and the filing of any required alternative valuations, the net Stranded Cost resulting from all such determinations shall be the "Final Stranded Cost Amount."

28. Under the Net Revenues Lost methodology, Stranded Costs are measured as the net present value of the annual differences between the expected revenues under a continuation of regulation and those likely to be received after the introduction of retail competition.

. . .

29. The approach recognizes that utilities that made investment decisions under the traditional regulatory paradigm expected a revenue stream from customers to cover the cost of such investments over their useful lives.

30. The Net Revenues Lost methodology proposed by TEP is a reasonable means of determining Stranded Costs.

31. Stranded Cost estimates, assuming divestiture, have been provided to the Commission pursuant to the terms of a Protective Agreement.

32. Estimates of TEP's Final Stranded Cost Amount range from $600 million to 1.1 billion.

33. The actual Final Stranded Cost Amount will ultimately be decided through divestiture of the Assets.

34. The estimates of TEP's Final Stranded Cost Amount set forth in TEP's Application are reasonable.

35. The categories of recoverable Stranded Costs identified by the Company in Schedule 3 of the Application are reasonable and recoverable by the Company. Transaction Costs necessary to divest the Assets and obligations associated with the Assets including, but not limited to, underwriters' fees, underwriters' counsel fees, rating agency fees, printing fees and other expenses related to the sale of the Transition Bonds are also recoverable.

36. The Commission is required "to prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected by" the Company for the electric service that the Company provides within its service territory.

37. The Commission is required to assure that all charges made for services rendered, or to be rendered, shall be just and reasonable, and no discrimination in charges, service, or facilities shall be made between persons or places for rendering a like and contemporaneous service.

38. To aid it in the proper discharge of its duties, the Commission is required to ascertain the fair value of the property of the Company within the State.

39. The Commission has determined that it will be in the public interest to implement a restructuring of the electric industry in this State whereby all retail customers will achieve direct access to the provider of electricity of their choice and that electricity will be priced at market rates.

. . .

40. Implementing an electric industry restructuring plan requires that the Commission determine the value of the property that the Company has dedicated to public service under past regulatory policies and that the Commission establish rates that will afford the Company a reasonable opportunity to recover that investment in a competitive electric market in the future.

41. The Company's Final Stranded Cost Amount to be recovered shall be determined by the Company after it completes the auction of its generation assets and obligations as described in the Application and authorized herein, estimated to occur before January 1, 2001.

42. The Company is entitled to be paid the Final Stranded Cost Amount, together with interest on the unpaid balance, until the entire Final Stranded Cost Amount is paid in full as provided in this Order. The right to be paid the Final Stranded Cost Amount, together with interest thereon, is a presently existing property right of TEP (the "Transition Property").

43. Under current regulation, the Company's right to receive payment of the Final Stranded Cost Amount, together with interest on the unpaid balance, is embedded in its present rates.

44. With the implementation of a competitive electric market, the Company is entitled to have its rates set at levels adequate to allow the Company the opportunity to be paid all of its prudently incurred costs to provide jurisdictional service, including the Final Stranded Cost Amount, together with interest on the unpaid balance.

45. If the Commission does not establish a uniform, nondiscriminatory, non-bypassable mechanism for the payment of the Final Stranded Cost Amount, together with interest on the unpaid balance, by all purchasers of electricity within TEP's present service territory after competition is authorized to begin, discrimination in charges, services and facilities would develop, for all customers that have access to competitively-priced electricity.

46. Establishing uniform payment of the Final Stranded Cost Amount by all purchasers of electricity for consumption within TEP's service territory, regardless of the entity supplying their electricity, will avoid such potential discrimination.

47. In order to provide for the fair and reasonable payment to the Company of the Final Stranded Cost Amount, together with interest on the unpaid balance, and to provide the substantial sum of cash required to complete the auction of its generation assets and obligations, the Company proposed that the Commission establish the CTC as a separate non-bypassable and irrevocable rate, on a per kWh, a kW and/or a fixed fee basis applied uniformly to all sales of electricity to customers

utilizing the Company's T&D system for consumption within TEP's present service territory. The CTC is applicable to customers purchasing electricity in the competitive market and as the Transition Component (the "TC" and, together with the CTC, the "Charges") of the Company's Standard Offer Tariff.

48. The Charges, subject to adjustment periodically, will be set at a level sufficient to recover the Final Stranded Cost Amount together with interest thereon over a period ending on or before December 31, 2008 (the "Recovery Period"), according to a schedule substantially similar to the schedule for payment of principal and interest on the Competition Transition Bonds ("CTBs") described below.

49. An automatic adjustment formula will be included in these tariffs pursuant to which the Charges will be adjusted at least annually by servicer, initially the Company, without further action by the Commission, to the extent that the aggregate amount actually collected pursuant to the Charges varies from the scheduled amount. The Charges will be adjusted from time to time to provide amounts sufficient to paying trustees fees, servicing fees, scheduled debt service, any required overcollateralization and the equity component of the Stranded Cost Amount if such amount shall become due or scheduled for payment. The Company will establish an interest rate on the unpaid balance of the Final Stranded Cost Amount at a level sufficient to pay interest on the CTBs plus an excess securitization spread. The Company expects that interest rate on the CTBs will be based on a "AAA" rating.

50. The Company's Application is predicated on the Commission establishing rates or charges for the payment of the Final Stranded Cost Amount, together with interest thereon, in a manner that gives rise to Transition Property that can be "securitized," *i.e.*, sold and transferred irrevocably to an entity that is independent of the Company for bankruptcy purposes and that can issue "AAA" rated indebtedness secured by the Transition Property.

51. The Transition Property shall continuously exist as property for all purposes with all of the rights and privileges defined in this Decision.

52. The Company will form a special purpose entity ("SPE"), wholly-owned by the Company, which is bankruptcy-remote from the Company, such that in the event of the Company's bankruptcy, the Transition Property will not be included in the Company's bankruptcy estate.

. . .

53. To use utility funds to form the SPE and to obtain a financial interest therein, the Company has requested such approval or waiver pursuant to A.A.C. R14-2-804.

54. The Company will contribute equity to the SPE and will sell the Transition Property to the SPE.

55. The SPE will issue debt instruments (CTBs) secured by the Transition Property and other assets of the SPE.

56. The proceeds of the sale of the CTBs, net of expenses, will be used to pay the Company the purchase price of the Transition Property.

57. The Company will use the proceeds of the sale of the Transition Property to conclude the auction of its Assets and obligations.

58. If any customer of the Company (or its successor) fails to pay its utility bill in full, any shortfall in revenues received will be allocated between the Charges and the Company's other rates and charges based on the ratio of the amount of the bills relating to the Charges and the amount relating to the Company's other charges.

59. The scheduled final maturity of the CTBs will be no later than December 31, 2008, with a legal final maturity to be determined based on market conditions at the time of issuance.

60. The principal amount of the CTBs will be the Final Stranded Cost Amount determined pursuant to the TEP auction process, and the interest rate on the CTBs will be determined by the Company based on capital market conditions at the time the CTBs are sold.

61. The Charges will be included as a separate line item on customers' bills as a CTC or TC, as applicable.

62. The Company will enter into a contract with the SPE pursuant to which the Company will be obligated to: i) bill and collect the Charges and remit them to the SPE or to a corporate trustee for the benefit of the holders of the CTBs; and ii) to maintain the Company's distribution system and billing and collection facilities and procedures (including disconnection for nonpayment) in such a manner that at all times the Company (or other entity designated by the SPE and/or holders of the CTBs) will be able to bill and collect the Charges (including adjustments thereto), regardless of ownership of the distribution system or power supplier.

63. In order to enable the Company to effect the financing of the Final Stranded Cost Amount as contemplated by this Order and thereby to implement retail competition within the

Company's service area, which the Commission has found to be in the public interest, it is necessary that the Transition Property and the provisions of this Order not be subject to change or risk of loss as a result of future Commission action, municipalization of the Company's distribution system, or future legislation authorizing municipal regulation of the rates of the Company unless outstanding CTBs are defeased by a portfolio of United States Treasury obligations.

64. The CTBs will be without recourse to the Company. Therefore, the SPE, any assignee of the Transition Property and the holders of the CTBs will be relying on this Order, including the agreement not to amend, repeal or modify the charges in any manner which would impair the ability of the SPE to make full and timely payments on the CTBs, in connection with the issuance, sale and purchase of the CTBs.

65. The Commission has the authority to establish a ratemaking mechanism that is fixed for a stated period of time (such as the Charges) when the Commission finds such fixed mechanism necessary in aid of its ratemaking authority and is in the public interest.

66. The Commission in the future may alter the Transition Property or the Charge, only if CTBs have previously been defeased by a portfolio of United States Treasury obligations.

67. In light of the Competition Rules and its Plan of Divestiture, TEP has requested waivers from various sections of the Commission's Rules and previously issued Commission orders set forth in Attachment A.

68. The interests of consumers of electricity within TEP's present service area will be best served by a shift from regulated monopoly service by TEP to open competition in the supply of electricity.

69. The interests of consumers of electricity within TEP's present service area will be best served if TEP divests all of its Assets no later than January 1, 2001.

70. It is not feasible for TEP to divest all of its Assets without raising a substantial amount of cash as the total of its required payments are likely to exceed the sale proceeds received for the assets. These payments include, but are not limited to: i) retiring tax-exempt, two-county debt; ii) making payments to lease participants or assignees of the leases; and iii) retiring other debt associated with the Assets sold.

. . .

. . .

71. TEP has agreed to divest the Assets in reliance on this Order that hereby finds that consumers of electricity within TEP's present service area are collectively obligated to pay TEP the Final Stranded Cost Amount, together with interest on the unpaid principal balance, and that the Commission in the future will not alter, amend or revoke the Charge or the automatic adjustment mechanism unless the CTBs have been repaid or defeased.

72. The securitization transaction described in TEP's Application will result in a significantly lower cost of capital than traditional TEP debt or equity securities or any other form of TEP financing proposed in connection with this proceeding.

73. The securitization transaction described in TEP's Application constitutes a "mitigation" of TEP's Stranded Costs.

74. Investors will purchase the CTBs in reliance upon this Order which provides that the Charge and the automatic adjustment mechanism will not be altered, amended or revoked unless the CTBs have been repaid or defeased.

75. Because Arizona is not establishing a power exchange similar to the California model, TEP requested that the Commission establish a mechanism which prohibits the generation affiliate of a Utility Distribution Company ("UDC") from offering generation services to a marketing affiliate on more favorable terms than would otherwise be available to unaffiliated marketers.

76. Unaffiliated marketers should have access to generation and generation services from the generation affiliate of a UDC on the same basis as the UDC's affiliates in order to provide a transparent market.

77. TEP proposed a minimum monthly reporting requirement of all affiliate transactions to be a condition for obtaining a competitive CC&N.

CONCLUSIONS OF LAW

1. TEP is a public service corporation within the meaning of the Arizona Constitution and A.R.S. § 40-203, § 40-250, § 40-251, § 40-285, § 40-301 and § 40-302.

2. The Commission has jurisdiction over TEP and the subject matter of the Application.

3. TEP has fully complied with Decision No. 60977.

4. TEP's Application should be approved consistent with the Findings of Fact contained herein.

. . .

5. TEP should be authorized to implement its Stranded Cost Recovery Plan as set forth in its Application, including, without limitation, its plan for divestiture, auction and securitization.

6. TEP should be authorized to recover 100 percent of its Final Stranded Cost Amount, together with interest on the unpaid balance.

7. The sale or other transfer of the Assets and related obligations set forth in the Application is in the public interest.

8. The SPE, as transferee of the Transition Property, should be authorized to recover the Transition Property, together with interest thereon, as set forth in the Application.

9. TEP should be authorized to charge an ICTC, a CTC and a TC as set forth in its Application.

10. On or before the date on which the CTBs are issued, the Transition Property will be an existing property right of TEP.

11. TEP should be authorized to securitize the Charges by transferring the Transition Property to the SPE in exchange for cash.

12. The securitization of the Charges and the transfer of Transition Property to the SPE is in the public interest and represents an important mitigation of the Company's Stranded Costs as required by Decision No. 60977.

13. Once CTBs have been issued in connection with the sale of the Transition Property and securitization of the Charges, the Commission may not alter the Charge or the Transition Property without either i) providing the SPE sufficient revenues to redeem or defease the securities, or ii) obtaining consent from the SPE, TEP (or a successor servicer) and the CTB trustee.

14. The transactions approved herein are for lawful purposes within TEP's corporate powers, are compatible with the public interest, with sound financial practices and the proper performance by TEP of service as a public service corporation and will not impair TEP's ability to perform that service.

15. The transactions approved herein are for the purposes stated in the Application and are reasonably necessary for those purposes, and such purposes are not, wholly or in part, reasonably chargeable to operating expenses or to income.

. . .

. . .

16. If TEP is unable to divest itself of one or more of its generation resources, TEP should be authorized to recover 100 percent of the Final Stranded Cost Amount associated with such asset(s) through a "net lost revenue approach" over a ten-year period.

17. At the end of the Transition Period, consumers of electricity within TEP's present service area collectively will become obligated to pay TEP the Final Stranded Cost Amount, together with interest on the unpaid principal balance.

18. The Commission should not alter, amend or revoke the Charge or the automatic adjustment mechanism unless i) the CTBs have been repaid or defeased by a portfolio of United States Treasury obligations, or ii) consent has been obtained from the SPE, TEP (or a successor servicer) and the CTB trustee.

19. TEP should be authorized to form the SPE pursuant to A.A.C. R14-2-804.

20. TEP's request for waivers as set forth in Attachment A attached hereto should be approved.

21. The Commission should adopt a mechanism which prohibits the generation affiliate of a UDC from offering generation services to a marketing affiliate on more favorable terms than would otherwise be available to unaffiliated marketers. Unaffiliated marketers should have access to generation and generation services from the generation affiliate of a UDC on the same basis as the UDC's marketing affiliates.

ORDER

IT IS THEREFORE ORDERED that TEP's Application is hereby approved in its entirety.

IT IS FURTHER ORDERED that TEP is hereby authorized to proceed with an auction and sale or other transfer of the Assets set forth in its Application.

IT IS FURTHER ORDERED that TEP may establish an ICTC, a CTC and a TC that will allow it to recover 100 percent of its Final Stranded Cost Amount, together with interest on the unpaid balance, as set forth in Exhibits C and D of its Application.

IT IS FURTHER ORDERED that the initial Charges shall be filed with the Commission and will be effective on filing.

IT IS FURTHER ORDERED that the Company's tariffs shall include the automatic adjustment formula, as described in the Application, pursuant to which the Charges will be adjusted periodically (at least annually) to the extent that the aggregate amount actually collected pursuant to the Charges varies from the amount required under the Payment Schedule for any reason whatsoever (including, without limitation, damage to the distribution system, change in energy consumption and default by an energy service provider). Automatic adjustments shall be made by the Company, or by any successor servicer or other party acting on behalf of the owners of the Transition Property, without further action by the Commission.

IT IS FURTHER ORDERED that upon the written request of the Company or a successor servicer, accompanied by the written consent of the CTB trustee, the Commission may modify or alter the automatic adjustment formula.

IT IS FURTHER ORDERED that the holder(s) of the Transition Property will be entitled to recover the Charges in the aggregate amount equal to the Final Stranded Cost Amount, together with interest thereon, to be paid as set forth in the Payment Schedule.

IT IS FURTHER ORDERED that the Commission approves the sale by the Company of the Transition Property to the SPE. The proceeds of sale of the Transition Property shall be used to conclude the divestiture of the Company's generation-related assets and obligations. Any additional proceeds of the sale of the Transition Property may be used for any lawful purpose.

IT IS FURTHER ORDERED that upon the sale by the Company of the Transition Property to the SPE: i) the SPE shall have all of the rights originally held by the Company with respect to such Transition Property, including, without limitation, the right to exercise any and all rights and remedies to collect any amounts payable by any customer in respect of the Transition Property, notwithstanding any objection or direction to the contrary by the Company; and ii) any payment by any customer to the SPE will discharge such customer's obligations in respect of such Transition Property to the extent of such payment, notwithstanding any objection or direction to the contrary by the Company.

IT IS FURTHER ORDERED that upon sale by the Company of the Transition Property to the SPE, the Company shall not be entitled to recover the Charges associated with the Transition Property other than for the benefit of the SPE or its transferee, in accordance with the Company's duties as servicer.

IT IS FURTHER ORDERED that the pledge by the SPE of the SPE's right, title and interest in and to the Transition Property and the SPE's other assets as security for the CTBs is approved.

. . .

IT IS FURTHER ORDERED that the SPE is approved to issue CTBs on terms and conditions described in this Order in aggregate principal amount not to exceed the Final Stranded Cost Amount approved by the Commission.

IT IS FURTHER ORDERED that in the event of default by the Company in its obligation to turn over the collections with respect to the Charges to the SPE, the Commission, upon the application by: i) the holders of the CTBs and the trustees or representatives therefor; or ii) the SPE or its assignees, will order the sequestration and remittance to the party entitled thereto of the collections with respect to the Transition Property.

IT IS FURTHER ORDERED that to the extent that any interest in such Transition Property is sold, assigned, or otherwise transferred, whether absolutely or for security, the Company, or its successor, shall continue to operate its distribution system to provide service to its customers, and, as servicer under the transaction documents associated with the CTBs, collect amounts in respect of the Charges for the benefit and account of the SPE, and account for and remit these amounts to or for the account of the SPE.

IT IS FURTHER ORDERED that the Company shall enter into a contract with the SPE pursuant to which the Company is obligated to: i) bill and collect the Charges and remit them to the SPE or to a corporate trustee for the benefit of the holders of the CTBs; and ii) maintain the Company's distribution system and billing and collection procedures and facilities (including disconnection for nonpayment) in such a manner that at all times the Company (or other entity designated by the SPE and/or holders of the CTBs) will be able to bill and collect the Charges (including adjustments thereto), regardless of ownership of the distribution system or power supplier. Such contract shall include a provision granting the owners of the Transition Property and the holders of the CTB, or the representatives of either, the irrevocable right to use the distribution system and billing and collection procedures and facilities (including disconnection for nonpayment), and have full right of access thereto, to whatever extent necessary to receive the Transition Property in the manner set forth herein and in the tariffs.

IT IS FURTHER ORDERED that the Company and each successor servicer shall separately state the Charges for the purpose of each customer's bill.

. . .

. . .

IT IS FURTHER ORDERED that the Company and each successor servicer shall allocate amounts collected from a customer pro rata between the Charges and the Company's other rates and charges.

IT IS FURTHER ORDERED that in the event of failure of any customer to pay the Charges, the Company shall terminate service to such customer in accordance with Commission-approved termination policies, at the direction of the servicer.

IT IS FURTHER ORDERED that the Company shall not voluntarily resign as initial servicer without prior approval of the Commission.

IT IS FURTHER ORDERED that until payment in full or defeasance of the Final Stranded Cost Amount, together with interest thereon, and the payment in full of the CTBs, including all principal, accrued interest, premium, costs, and arrearages thereon, or adequate provision for such payment is made or unless consent is obtained from the SPE, TEP (or a successor servicer) and the CTB trustee, the Commission agrees not amend, modify or repeal this Order or any of its ordering paragraphs or the Charges, except for any amendment that further protects the rights of the owner of Transition Property and the holders of the CTBs and which will not impair the full and timely payment of the Charge to the extent required to provide funds necessary to make timely payments on the CTBs.

IT IS FURTHER ORDERED that the Company shall include in the tariffs establishing the Charges a provision that, in the event that: i) any portion of the distribution system of the Company is acquired by an entity other than a public service corporation regulated by the Commission; or ii) any portion of the distribution system becomes subject to rate regulation other than by the Commission, unless some other provision is made for the defeasance of the CTBs, each customer then subject to payment of the Charges shall immediately pay an exit charge equal to that customer's pro rata share of the then outstanding principal of, and accrued interest on, the Final Stranded Cost Amount, such pro rata share to be based on that customer's electricity usage for the most recent twenty-four complete billing cycles.

IT IS FURTHER ORDERED that the Commission's approval of the creation of the Transition Property and its transfer to the SPE for the purposes herein described shall constitute the Commission's final and complete approval of the transfer and sale of the Company's facilities pursuant to A.R.S. § 40-285.A.

IT IS FURTHER ORDERED that if TEP is unable to divest itself of one or more of its generation assets, it is hereby authorized an opportunity to recover 100 percent of the Stranded Cost associated with such resources through a "net lost revenues" approach over a ten-year period as set forth in the Application.

IT IS FURTHER ORDERED that TEP's request to form the SPE is hereby approved.

IT IS FURTHER ORDERED that TEP's requests for waivers as set forth in Attachment A is hereby approved in its entirety.

IT IS FURTHER ORDERED that the Commission shall adopt a mechanism which prohibits the generation affiliate of a UDC from offering generation services to a marketing affiliate on more favorable terms than would otherwise be available to unaffiliated marketers. Unaffiliated marketers will have access to generation and generation services from the generation affiliate of a UDC on the same basis as the UDC's marketing affiliates.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, JACK ROSE, Executive Secretary of the Arizona Corporation Commission, have hereunto set my had and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ______ day of _______, 1998.

JACK ROSE
EXECUTIVE SECRETARY

DISSENT ________________

Attachment A

WAIVERS OF COMMISSION RULES AND ORDERS

The following rules and orders of the Commission are hereby waived until further order by the Commission:

- A.A.C. R14-2-701, *et seq.* - Integrated Resource Planning Rules
- A.A.C. R14-2-801, *et seq.* - Affiliate Interest Rules
- Decision No. 60480, Attachment A - Condition Nos. 2, 12, 13, 17, 19, 20, 21, 25, 26, 27, and 28 - Holding Company Order
- Decision No. 59594 - Cost Containment Report and Mid-Year DSM and Renewables Report
- Decision No. 57586 - Director Transaction Report
- Decision No. 58316 - Investment Subsidiary Liquidation Report and Purchase Agreement Summary
- Decision No. 58497 - Avoided Cost Report
- Decision No. 57090 - Time of Use Letters
- Decision No. 56659 - Time of Use Report

Other Reports or Filings not Necessary Post-Divestiture

- Decision No. 56526 - Fuel & Performance Filing
- Decision No. 57924 - Interruptible Report
- Statistical Data on Generating Units
- Generating Unit Outage Report

Exhibit B

Proposed Auction Procedures and Protocols

The Company is seeking approval of the procedures and protocols ("Protocols") described below. Such Protocols govern the conduct of the auction in general and the "rules" to be followed by each participant.

The Protocols provide potential bidders with the details of the auction process, including the methodology and tentative timetable as outlined in Section VI of this Application, rules of conduct and the form of bid. The Protocols will also reserve the Company's right to amend or alter any part of the process due to regulatory decisions or other events that in the Company's judgment make such changes necessary.

The Protocols will be contained in the Confidentiality and Protocols Agreement (the "Agreement") which each potential bidder will be required to execute prior to participating in the auction process.

The Agreement will obligate the potential bidder, its affiliates and representatives to maintain as confidential any information, documents, data or any other material provided by Company ("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 also be required to treat as confidential any bid or related discussions it has with the Company. Bidders will also agree to return or destroy all Due Diligence Material at the request of TEP. Destruction of Due Diligence Material shall be certified by an officer of the bidder.

Due Diligence Material provided to participants in the process will include, among other things, a Selling Memorandum, any third-party environmental or engineering reviews performed for the Company 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.

The Company will use its best efforts to keep information supplied by potential bidders confidential in the course of regulatory filings, hearings or decisions. Any information requested by the Commission regarding the participants in the auction, including bids, will be filed under confidentiality.

THE AUCTION PROCESS

The auction is designed to ensure that all bidders have the same opportunity to evaluate and bid on the Assets. The phases of the auction outlined below provide structure to the process and to allow all bidders to be on an equal basis with regard to information access during their due diligence review. The methodology also allows TEP flexibility to adjust the timetable or other aspects of the process, if necessary. The primary phases of the Auction are:

(i) Pre-Auction activities ("Phase I")
(ii) Initial Indications round of due diligence and bidding ("Phase II")
(iii) Final Bid round due diligence and bidding ("Phase III")

(iv) Negotiation and execution of transaction agreements ("Phase IV")
(v) Regulatory and other necessary approvals and consents ("Phase V")

Phase I

Phase I 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 II). Phase I activities will include gathering all of the information necessary for bidders to conduct their due diligence. The Due Diligence Material will include operating, financial, environmental, legal and technical information on the Assets which will be organized by generating facility and subject into a data room (or possibly multiple data rooms) to be used by Bidders during their due diligence. TEP will also forward certain Due Diligence Material directly to bidders to streamline the due diligence process and to allow bidders the opportunity to use their time more efficiently. TEP will determine prior to the beginning of Phase II what information to supply to bidders directly and the information to be included in the data room(s). A significant part of the Phase I activities will be a thorough review of all relevant contracts, permits, easements and other pertinent documents associated with the Assets necessary to transfer ownership. In addition, all necessary consents and approvals will be identified that are necessary to complete the transfer of the Assets.

TEP will retain environmental and engineering firms to conduct independent reviews to be included as part of the Due Diligence Materials.

In addition, a Selling Memorandum will be prepared, which will include relevant information on all aspects of the Assets, as will necessary transaction documents ("Documents").

During Phase I, it will be important to establish the level of interest in the market for the Assets, and to reserve time and resource allocations on bidders' calendars. New Harbor Incorporated will assist TEP by identifying and contacting a wide range of potential purchasers. This will include sending a non-confidential descriptive summary of the Assets. The Agreement, including the tentative timetable, will be distributed to bidders, as will the qualifications necessary for bidders to participate in the auction. TEP will also prepare a press release to include in industry and financial publications directing bidders to contact New Harbor in order to be included in the process.

Phase II

Phase II of the process will begin after the Commission approves this Application and all other significantly regulatory decisions that would impact the timing, certainty or economics of the process have been decided. A revised timetable will be sent to bidders to the extent there have been changes to the timetable included in this Application.

Parties receiving the Agreement and Due Diligence Material will have the time indicated on the tentative timetable to review the materials and to submit written questions to TEP. In addition, TEP may ask for comments to the major terms and conditions contained in the Documents, and determine whether to make any changes and to the extent changes are made the Documents will be re-circulated to bidders for review prior to submitting their preliminary bids. Following the initial review period, bidders will be asked to submit non-binding Indications of Interest. The Indications of Interest are designed to have all bidders provide the same information so that they can be compared on an "apples to apples" basis. The basic information that all bidders will be required to provide is outlined below.

TEP will evaluate the Indications of Interest and select a "short list" of bidders to invite into Phase III, 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 a transaction and any consents or approvals necessary that could significantly delay a closing.

Phase III

Bidders invited to participate in Phase III will be provided additional Due Diligence Material, access to a data room(s), the opportunity to conduct site visits as well as time to ask questions about the Assets to TEP management and other personnel knowledgeable about the Assets. This will be a more extensive due diligence period requiring a higher level of resources and commitment from the bidders. TEP will circulate the Documents for review and comment by bidders. TEP will re-circulate the Documents to bidders if any changes are accepted, and will provide bidders sufficient time to incorporate them into their final bids. Because the Documents will be filed with the Commission for pre-approval, the Company does not anticipate making material changes to the Documents.

Bidders will have the time indicated on the timetable for Phase III to conduct second round due diligence at which time final bids ("Final Bids") will be submitted.

Phase IV

Final Bids for the Assets will be evaluated on a similar basis to the Initial Indications of Interest and winning bidders will be selected. Bidders will be required to be available to meet with TEP for final negotiations and contract execution. Bidders will be required to provide specificity regarding any final due diligence that may be required prior to signing the Documents and TEP will take these into consideration in its evaluation of the Final Bids.

Phase V

TEP will submit executed Documents to the Commission for approval. The Commission will have the opportunity to review the filing to satisfy itself that the Auction was conducted in a manner consistent with this filing. It is TEP's objective that the pre-approvals being requested will result in a more rapid final approval of the transaction(s).

Asset Bundling

Bidders will have the opportunity to bid on any or all of the Assets. Bids will be taken on the following Assets:

(i) Springerville
(i) Irvington
(ii) TEP's 50% interest in each of Units 1 and 2 of the San Juan
(iii) TEP's 7% interest in each of Units 1 and 2 of Four Corners
(iv) TEP's 7.5% interest in each of Units 1, 2 and 3 of Navajo
(v) TEP's combustion turbines

TEP reserves the right 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 the revised bundling. The Assets are described more fully in Section II.

Bidding Restrictions

A bid only will be deemed acceptable following the execution of all Documents by TEP and the winning bidder. TEP reserves the right and is under no obligation to accept any bids. TEP requests the Commission not entertain third-party bids for the Assets. The Commission will only approve transfers of any Asset(s) to purchasers who have participated in the auction process and been selected as the winning bidder for such Asset(s).

TEP reserves the right to at any time, in its sole discretion, to select which bidders to invite to Phase III, Phase IV or the bidder(s) with which to execute Documents, terminate discussions with any or all bidders, amend or otherwise change the protocols and/or suspend or terminate the auction. Should TEP elect to suspend or terminate the auction, TEP will notify the Commission and all bidders of such decision, the reasons for such a decision and TEP's subsequent course of action.

Bidders will be required to notify TEP prior to entering into any partnership, joint venture, consortium, or other association or organization. All parties to such a bid will be required to execute the Agreement prior to their inclusion in the auction or their receipt of any Due Diligence Material.

Communication

Bidders will be required to direct all communications to New Harbor or a designated representative of TEP. Bidders will be notified of a TEP representative.

Form of Bid

Bidders will be required to include, at a minimum, the following information when submitting their Indications of Interest. Subsequent bids will be in such form as TEP may request.

(i) The purchase price or range of purchase prices for the Asset(s)
(ii) Sources of financing
(iii) Financial information including the most recent 10-K, 10-Q or audited financial statements for non-public bidders
(iv) Consents and/or approvals required to complete a transaction
(v) Bidder contacts, including phone and fax numbers to discuss the preliminary bid
(vi) List of outside advisors

The form of bid will be adjusted, if necessary, to conform with the structure of the final transaction. TEP will short-list based on price, financial ability to close a transaction and significant bid contingencies.

No Obligation

Nothing contained in the Protocols, Due Diligence Material or other information provided by TEP to a potential bidder, whether written or oral, shall obligate TEP with respect to the operation or condition of the Assets. TEP will only be obligated to the terms and conditions of the Documents executed between TEP and the winning bidder(s).

Bid Confidentiality

All aspects of the auction are subject to the terms and conditions of the Agreement. In addition, individual or group bidders that have complied with the disclosure requirements in forming their respective group, are not to disclose their bids to any party without obtaining TEP's prior consent. Bidders are not to discuss any aspect of their participation in the auction to any other party without first obtaining TEP's consent. Violation of these conditions may result in disqualification from the auction.

Bidder Recourse

A bidder's sole recourse with respect to the auction will be to make a filing with the Commission claiming that TEP failed, in a material manner, to conduct the auction in accordance with the protocols set-forth in this application and subsequently agreed to by potential bidders. A bidder's sole remedy will be for the Commission to require TEP to re-run that portion or portions of the auction in accordance with the approved protocols.

Costs

Bidders will be responsible for their own costs in connection with the auction. TEP will in no way be liable for any bidder costs, including any costs resulting from the termination of the auction. The Company may consider the payment of a break-up fee to the winning bidder on Navajo, San Juan or Four Corners, in the event a right of first refusal is exercised by a participant with respect to the Asset bid upon, resulting in the winning bidder failing to obtain the Asset.

Interim Competition Transition Charge Tariff

1. Purpose

The purpose of the Interim Competition Transition Charge ("ICTC") is to provide TEP with a reasonable opportunity to recover the Company's above-market generation costs during the period January 1, 1999 through the date the Competitive Transition Charge ("CTC") mechanism is implemented. Upon final divestiture, TEP will present to the Commission final stranded costs associated with divesting TEP's generation when the costs are known and measurable as required per ACC Decision No. 60977.

2. Applicability

TEP's ICTC shall be recovered from all existing and future consumers in the service territory in which TEP provides transmission and distribution service, except as specifically delineated in Item 5 of this tariff.

3. Definitions

1) Cost of Capital

The monthly Cost of Capital is one-twelfth of TEP's authorized Cost of Capital approved by the Commission.

2) NYMEX Palo Verde Index ("NYMEX")

Index TEP will use to forecast the market price for energy at Palo Verde. Electricity futures contracts are traded publicly at the New York Mercantile Exchange. Palo Verde Switchyard futures contracts are traded for monthly on-and off-peak periods for 18 forward months. A futures contract is an agreement between a buyer and seller for delivery of a particular quantity of a commodity at a specific time, place and price. The price of the futures contract reflects the current market consensus of commodity price expectations in the future.

3) Dow Jones Palo Verde Index ("PVI")

Index TEP will use to determine the actual cost of generation in Arizona. The Dow Jones Palo Verde Index is a measure of actual spot market prices. Dow Jones collects volume and price data from the majority of entities who transact physical power at the Palo Verde Switchyard. The transaction data relates to daily and hourly trades only, it does not include monthly or longer transactions executed in the OTC or NYMEX markets. The Palo Verde Index also excludes any transactions at Palo Verde scheduled to the California ISO.

4) Transition Period

Period between January 1, 1999 until the level of the CTC has been established and authorized for collection.

5) Departing Load

Any Standard Offer customer who chooses an Electric Service Provider other than TEP.

4. Interim Transition Cost Balancing Account (ITCBA)

1) General Principles

a) TEP shall maintain an ITCBA, and make entries on a monthly basis.

b) The monthly accumulated balance in the ITCBA (either under-or over-collections) shall accrue interest at a rate equal to TEP's overall Cost of Capital.

c) If the projected PVI during the month is less than the actual PVI, a credit will be made to the ITCBA.

d) If the projected PVI during the month is greater than the actual PVI, a debit will be made to the ITCBA.

e) Any balance (over-or under-recovery) of the ITCBA at the date of divestiture will be applied to the final determination of the CTC as an addition or reduction in the amount.

f) The UDC will have the responsibility of collecting the CTC either directly from customers or from ESPs.

2) Reporting Requirements

a) TEP shall provide quarterly reports to the Commission on the status of the ITCBA.

b) TEP shall provide to the Commission a forward-quarter PVI thirty days prior to the start of the quarter. In conjunction with this filing, TEP will provide the ICTC component by rate schedule to be charged during the quarter for Standard Offer and Departing Load.

3) Accounts

a) ICTC revenues will be recorded in TEP's revenue accounts along with the market price of generation.

b) The ITCBA shall record all adjustments to actual monthly PVI prices and ICTC.

c) Per R14-2-1613N of the Electric Restructuring Rules, all customer bills after January 1, 1999 will list, at a minimum, the following billing cost elements:

1. Electricity Costs
   a) Generation
   b) Interim Competition Transition Charge ("ICTC")
   c) Fuel or purchased power adjuster, if applicable

2. Delivery Costs
   a) Distribution Services
   b) Transmission Services
   c) Ancillary Services

3. Other Costs
   a) Metering Services
   b) Meter Reading Services
   c) Billing and Collection Services
   d) System Benefits Charge

TEP will record the above categories within the appropriate Revenue Accounts on the Company's Books.

c) A contra account will be linked to the Revenue ICTC Account to reflect any over- or under-recovery of the ICTC amount in any month. The Contra ICTC Account will reflect adjustments to the actual ICTC amount collected from customers.

d) An ITCBA will be established to account for the over or under-recovery ICTC liability of the Company or customers on a monthly basis.

5. Exceptions to ICTC

Existing and future consumers in the service territory in which TEP provides transmission and distribution service will be excluded from the ICTC Charge in the following instances:

Self-Generation, Demand-Side Management or Other Demand Reduction Attributable to any causes other than the Retail Access Provisions of Article R14-2-1607

Per R14-2-1607, any reduction in electricity purchases from an Affected Utility resulting from self-generation, demand-side management or other demand reduction attributable to any cause other than the retail access provisions of Article R14-2-1607 shall not be used to calculate or recover any Stranded Cost from a consumer.

6. Calculation of the ICTC

The ICTC will be calculated as follows:

a) PVI will be forecasted quarterly via the NYMEX and compared to the actual PVI to determine the proper level of ICTC during the Transition Period. If the difference between the forecasted and actual PVI price for a given quarter is outside a band ranging between 2 to 4 cents/kWh for on-peak firm energy, TEP will seek Commission approval to adjust the following quarter for the given quarter's over-or under-recovery. If the difference between the forecasted and actual PVI price for a given quarter is inside the band, TEP will adjust the following quarter's NYMEX to reflect the over- or under-collection from the previous quarter. Based on the first quarter 1999 projection of Palo Verde power prices based on the NYMEX, TEP will unbundle the generation component of the Standard Offer between the forecasted Palo Verde quarterly market price and the ICTC. The ICTC is the difference between the traditional embedded generation costs and the quarterly Palo Verde estimate [Standard Offer Embedded Cost of Generation - Palo Verde Price = ICTC]. For example, if the quarterly NYMEX for Palo Verde on-peak, off-peak weighted-average price for the first quarter of 1999 is assumed to be 2.2 cents and TEP's embedded generation cost for Residential Rate 01 under the Standard Offer is 6.2 cents, the Residential Rate ICTC for the Standard Offer is 4.0 cents. This Residential Rate 01 ICTC charge will be charged to all Standard Offer Customers for the first quarter of 1999.

b) TEP will charge competitive customers the same ICTC per rate schedule as the Standard Offer customer. The ICTC rate for each rate schedule will remain in effect for the first quarter of 1999.

c) TEP will adjust the ITCBA to the actual PVI balance monthly. Any over-or under-recovery of the ICTC will be recorded in the ITCBA Account.

d) Any over-or under-recovery of the ICTC in the previous quarter will accrue interest based on the Company's approved cost of capital.

e) TEP will repeat the process for the second quarter of 1999.

7. Standard Offer Unbundling

The generation portion of each rate schedule will be utilized to determine the ICTC amount during the transition period.

The generation portion of each rate schedule that will be used to determine the ICTC is as follows:

Schedule	No.	Rate
Residential	(01, 70)	$0.0622 Per kWh
General Service	(10, 76)	$0.0794 Per kWh
Mobile Home Park	(11)	$0.0687 Per kWh
Interruptible Agricultural Pumping	(31)	$0.0382 Per kWh
Large General Service	(13, 85)	$0.0600 Per kWh
Large Lighting & Power	14, 90	$0.0576 Per kWh
Private Street and Area Lighting	(41, 50, 51)	$0.0320 Per kWh
Public Authorities Firm Interruptible	(40, 43)	 $0.0629 Per kWh $0.0398 Per kWh

Competition Transition Charge and Transition Component Tariff

1. Purpose

The purpose of the Competition Transition Charge ("CTC") and the Transition Component ("TC") is to allow TEP to recover the Company's Final Stranded Cost Amount, together with interest thereon, as the electric industry moves to a competitive generation market, to the extent that those costs have not been recovered by means of the ICTC. The Final Stranded Cost and the level of CTC and TC will be determined upon divestiture of the Company's generating assets.

2. Applicability

The CTC and TC shall be recovered from all existing and future consumers in the service territory in which TEP presently provides transmission and distribution service, except as specifically delineated in Item 9.

3. Definitions

1) Cost of Capital

The monthly cost of capital is one-twelfth of TEP's cost of capital to be authorized by the Commission.

2) Final Stranded Cost Amount

The Final Stranded Cost Amount under this tariff is the costs associated with divesting/auctioning TEP's generation assets and obligations associated with those assets. In addition to the Stranded Costs defined by A.A.C. R-14-2-1601.28, Final Stranded Cost Amount includes all are reasonable costs (i.e., costs incurred for premiums, penalties or other payments necessary to effect divestiture; income tax ramifications of divestiture; redemption costs associated with tax-exempt two-county debt which have to be redeemed upon transfer of the assets; and other reasonable costs necessarily incurred to effectuate divestiture, and the issuance of Competition Transition Bonds ("CTBs").

3) Recovery Period

Per ACC Decision No. 60977, the maximum recovery period of the CTC will be ten years, ending December 31, 2008.

4. Regulatory Asset Account

1) General Principles

a) TEP will record as a Regulatory Asset the Final Stranded Cost Amount.

b) TEP will separate the Regulatory Account into the following sub-categories:

1) Gain or Loss on Sale of Generating Units by Unit
2) Payments to Assign/Terminate Leases
3) Generation-Related Regulatory Assets
4) Employee-Related Severance and Retraining Costs
5) Divestiture Transaction Costs
6) Other Divestiture Costs not accounted for above.

c) The SPE, as transferee of TEP, will be permitted to collect 100 percent of the Final Stranded Cost Amount, including interest on the unpaid balance, over ten years from the date of the ultimate Commission decision that addresses Stranded Costs.

d) A component of the Final Stranded Cost Amount will be the ITCBA balance from TEP's Interim Competition Transition Charge Tariff.

e) To the extent that the recovery of the Final Stranded Cost Amount is ± 5% of the amount scheduled to be collected in a given calendar year, the CTC and TC will be adjusted to reflect the over-or under-recovery of Stranded Costs.

f) The Regulatory Asset Account will accrue interest on the uncollected balance of the Regulatory Asset based on the authorized cost of capital.

g) TEP or any successor will have the responsibility to collect the CTC or TC either directly from customers or from ESPs.

2) Reporting Requirements

a) Costs accumulated to date in the Stranded Cost Regulatory Asset Account will be reported to the Commission quarterly providing the Commission sufficient detail as to the nature of these costs.

3) Accounts

a) Per R14-2-1613N of the Electric Restructuring Rules, all customer bills at the conclusion of the Transition Period will list, at a minimum, the following billing cost elements:

1. Electricity Costs
   a) Generation
   b) CTC and TC
   c) Fuel or purchased power adjuster, if applicable

2. Delivery Costs
   a) Distribution Services
   b) Transmission Services
   c) Ancillary Services

3. Other Costs
   a) Metering Services
   b) Meter Reading Services
   c) Billing and collection Services
   d) System Benefits Charge

TEP will record the above categories within the Revenue Accounts on the Company's Books.

5. Final Determination of Stranded Cost

Upon divestiture of TEP's generating assets, TEP will file a final report on the Regulatory Asset Account for all costs of divestiture.

6. Allocation of Final Stranded Cost Amount

Upon divestiture, TEP will allocate Final Stranded Cost Amount among TEP's rate schedules based on the generating component of the Standard Offer in existence pre-divestiture. All rate schedules initially will be charged their proportionate share of the Final Stranded Cost Amount.

7. Determination of CTC Level

TEP will provide the Commission a forecast of its expected level of kWh sales by rate schedule the UDC will incur by year for a period not exceeding ten years.

Based on the level of kWh sales, TEP will provide the Commission with various scenarios of CTC and TC levels depending on the length of time the CTC is in force.

8. Regulatory Asset Adjustment Mechanism ("RAAM")

TEP will file annual reports with the Commission providing the following:

a) Actual amount of CTC and TC remaining to be collected by rate schedule.

b) Variance of actual rate schedule kWh sales to estimates provided.

c) Required adjustment to the level of CTC and TC by rate schedule, if needed.

The purpose of the RAAM is to provide assurance for recovery of 100% of the Final Stranded Cost Amount that the Commission has allowed through the CTC and TC. The CTC and TC level will be set on estimated kWh sales by rate schedule. Adjustments of the estimates to actual and periodic review and adjustment of the CTC and TC charge will ensure recovery of the Final Stranded Cost Amount approved by the Commission. The RAAM mechanism is necessary to comply with the Commission's Order to divest TEP's generation assets. Securitization will allow TEP to proceed with divestiture and cannot occur without the RAAM mechanism. One of the key conditions of securitization is that an automatic adjustment is approved by the ACC pursuant to which the CTC and TC are adjusted periodically to the extent the total amount actually collected pursuant to the CTC and TC varies from the amount required to pay scheduled principal and interest on the CTBs and associated expenses.

9. Exceptions to CTC and TC

Existing and future consumers in the service territory in which TEP provides distribution service will be excluded from the CTC and TC in the following instances:

a) Exit Fee

Upon notifying the UDC in writing of the customer's intent to pay an exit fee in lieu of a CTC or TC, the UDC will calculate an exit fee to be presented to the customer. The customer will continue to pay the CTC or TC until the UDC has received payment of the exit fee.

The exit fee will be calculated as the net present value of the remaining stream of CTC or TC payments for that customer class assigned to that customer using the cost of capital approved by the Commission. The customer's historical load (average of last two years) will be used as a basis for the calculation of the exit fee.

b) Self-Generation, Demand-Side Management or Other Demand Reduction Attributable to Any causes other than the Retail Access Provisions of Article R14-2-1607.

Per R14-2-1607, any reduction in electricity purchases from an Affected Utility resulting from self-generation, demand-side management or other demand reduction attributable to any cause other than the retail access provisions of Article R14-2-1607 shall not be used to calculate or recover any Stranded Cost from a consumer.

Schedule 1

Summary of Leveraged Lease Transactions

I. Irvington Lease

Irvington Unit 4 was sold in 1988 for a purchase price of $152 million, of which approximately $31 million was contributed by an owner participant and the balance of approximately $121 million was attributable to publicly issued lease debt in the form of industrial development bonds. At June 30, 1998, the capitalized lease asset relating to Irvington Unit 4, net of accumulated amortization, was $109 million. Annual lease payments for the Irvington Lease will range from $11 million to $14 million, averaging approximately $13 million. As of January 15, 1998, approximately $91 million of principal amount of debt remained outstanding. The Irvington Lease expires in 2011, subject to fair market value purchase and renewal options at the end of the lease term.

II. Springerville Common Facilities Leases

In three separate but substantially identical transactions, as to terms and conditions but not as to amount, consummated in 1985, the Company's undivided one-half ownership interest in the common facilities at Springerville was sold for an aggregate purchase price of $132 million, of which approximately $26 million was contributed by owner participants and approximately $106 million was contributed by lease debt participants. At June 30, 1998, the capitalized lease asset relating to the Springerville Common Facilities, net of accumulated amortization, was $118 million. Annual lease payments for the Springerville Common Facilities Leases vary with changes in the interest rate on the underlying debt. Based on current interest rates, average annual lease payments would total approximately $10 million. As of July 1, 1998, approximately $74 million principal amount of debt remained outstanding. One of the Springerville Common Facilities Leases will expire in 2017 and the remaining two Springerville

Common Facility Leases will expire in 2021, subject to fair market value purchase and renewal options at the end of the lease term.

III. Springerville Coal Handling Facilities Leases

In three separate but substantially identical transactions, as to terms and conditions but not as to amount, consummated in 1984 and supplemented in 1985, Valencia Energy Company ("Valencia") sold the coal handling facilities serving Springerville for an aggregate purchase price of $188 million, of which approximately $62 million was contributed by owner participants and approximately $126 million was contributed by lease debt participants. The Company guaranteed Valencia's obligations under the leases. In 1996, Valencia merged into the Company and the Company became the lessee under these leases. At June 30, 1998, the capitalized lease asset relating to the Springerville Coal Handling Facilities, net of accumulated amortization, was $173. Annual lease payments for the Springerville Coal Handling Facilities Leases will range from $10 million to $28 million, averaging approximately $21 million. As of July 1, 1998, approximately $110 million principal amount of debt remained outstanding. The Springerville Coal Handling Facilities Leases expire in 2015, subject to fair market value and fixed price purchase and renewal options at the end of the lease term

IV. Springerville Unit 1 Leases

In seven separate but substantially identical transactions, as to terms and conditions but not as to amount, consummated in 1986, Century Power Corporation ("Century") sold Springerville Unit 1 for an aggregate purchase price of $707 million, of which approximately $194 million was contributed by owner participants and the balance of approximately $513 million was contributed by lease debt participants. In December 1992, Century assigned to the Company its leasehold interests in Springerville Unit 1 and the Company assumed Century's obligations under the Springerville Unit 1 Leases. At June 30, 1998, the capitalized leased asset relating to Springerville Unit 1, net of allowance and accumulated amortization, was $408 million. Annual lease payments for the Springerville Unit 1 Leases will range from $33 million to $176 million, averaging approximately $78 million. As of July 1, 1998 approximately $460 million in principal amount of lease debt remained outstanding. The Springerville Unit 1 Leases expire in 2015, subject to fair market value purchase and renewal options at the end of the lease term.

V. Early Termination

The Company has no option to terminate the leveraged lease arrangements prior to the end of the lease term. Under certain specified circumstances, summarized below, the leases will terminate prior to the end of the lease term. Generally, in cases of such early termination, the Company will be obligated to pay the stipulated loss value set forth in the terminated Lease together with any unpaid rent and the premium, if any, payable on the lease debt. If each of the Leases terminated and the Company was obligated to pay stipulated loss value as of January 1, 2001, such payments would total approximately $1.2 billion (prior to any reduction based on the sales price of the Assets).

VI. Events of Loss

Each of the Leases is terminated upon an Event of Loss. Events of Loss are generally defined in the Leases to include total destruction of the leased assets, condemnation of title or use of the leased assets by a governmental authority, changes in law which preclude the commercial use of the facilities for their designed purpose and utility regulation of lease participants resulting from the transaction.

In the Springerville Common Facilities Leases, the failure to refinance the existing lease debt prior to January 1, 2000 gives rise to an additional Event of Loss resulting in the termination of such Leases.

Upon the payment of the stipulated loss value and any other amounts owing under a Lease for which an Event of Loss has occurred, the Lease terminates and title to the leased asset is transferred to the Company.

VII. Obsolescence Termination

Each of the Leases provides that the Company may terminate the Lease if the board of directors of the Company has made a good faith determination that the leased assets are obsolete or surplus to the Company's requirements. In the case of the Springerville Unit 1 Leases, such option does not exist until 2002. In the case of the Springerville Coal Handing Facilities, there is an additional requirement that the leased assets will no longer be used by any person for the handling of fuel for Springerville.

Each Lease generally provides that if an obsolescence termination option has been exercised by the Company, the leased asset must be sold at auction to a third party and that the Company must pay the excess of the stipulated loss value over the proceeds of sale, together with any other amounts owing under the Lease. Upon such a sale to a third party and the payments by the Company, the Lease terminates.

VIII. Sublease or Assignment

Each of the Leases provides that the Company may not, without the prior written consent of the lease participants, sublease the leased asset or assign any of its rights or interest the Lease or otherwise relinquished possession or use of the leased asset or permit the leased asset to be operated by any other person. Notwithstanding the foregoing, such an assignment or sublease may be made without consent to any direct or indirect wholly-owned subsidiary of the Company and consent shall not be unreasonably withheld by the lease participants in the case of a sublease to a third party having senior secured debt rated at least BBB+ by S&P and Baa1 by Moody's. No such assignment or sublease will relieve the Company of any of its obligations under the Leases.

To discharge or reduce the Company's obligations under the Leases in connection with the Leases, the consent of all lease participants (debt and equity) would be required.

Schedule 2

Mortgage Indentures

I. The 1941 Mortgage

A. General

The 1941 Mortgage provides for the issuance thereunder of multiple series of bonds, as discussed below under "Issuance of Additional 1941 Mortgage Bonds." All bonds issued under the 1941 Mortgage are collectively referred to herein as the "1941 Mortgage Bonds." Capitalized terms used under this heading which are not otherwise defined herein have the meanings ascribed thereto in the 1941 Mortgage.

At the date hereof, approximately $308 million in aggregate principal amount of 1941 Mortgage Bonds are outstanding (net of bonds called for redemption on September 3, 1998). The Company's Credit Agreement limits the aggregate principal amount of 1941 Mortgage Bonds which may be Outstanding under the 1941 Mortgage at any time to approximately $411 million.

B. Security

1. General

The 1941 Mortgage constitutes a lien on substantially all the real property and tangible personal property of the Company, other than property excepted from the lien thereof and such property as may have been released from the lien thereof in accordance with the terms thereof, subject to no liens prior to the lien of the 1941 Mortgage other than Permitted Encumbrances and certain other liens permitted to exist.

The 1941 Mortgage provides that after-acquired property (other than excepted property) will be subject to the lien of the 1941 Mortgage except in certain circumstances involving a consolidation, merger or similar transaction. In addition, after-acquired property may be subject to liens existing or placed thereon at the time of acquisition thereof, including, but not limited to, purchase money liens and, in certain circumstances, to liens attaching to such property prior to the recording and/or filing of an instrument specifically subjecting such property to the lien of the 1941 Mortgage.

2. Excepted Property

There are excepted from the lien of the 1941 Mortgage, among other things: i) bills, notes and accounts receivable, cash, choses in action, operating agreements and leases in which the Company is the lessor; ii) shares of stock, bonds and other securities (except those specifically subjected to such lien or required to be pledged); iii) goods and merchandise acquired for the purpose of sale in the ordinary course of business; and fuel, materials, supplies and other personal property which are consumable in their use in the operation of, or are not in use in connection with or connected as fixtures to, the plants and systems of the Company; and iv) the Company's franchise to be a corporation.

Properties held by subsidiaries of the Company, as well as properties leased from other Persons, are not subject to the lien of the 1941 Mortgage.

3. Issuance of Additional 1941 Mortgage Bonds

a. General

The aggregate principal amount of 1941 Mortgage Bonds which may be authenticated and delivered under the 1941 Mortgage is effectively unlimited. 1941 Mortgage Bonds of any series may be issued from time to time on the basis of, and in an aggregate principal amount not exceeding:

a. 60% of the Cost or fair value to the Company (whichever is less) of Net Property Additions (as described below) which do not constitute Funded Property;
b. the aggregate principal amount of Retired Bonds; and
c. an amount of cash deposited with the 1941 Mortgage Trustee.

Property Additions generally include any property which is properly chargeable to the utility plant accounts of the Company and is used or useful or to be used in the Utility Business. Net Property Additions means, generally, Property Additions (not theretofore funded by use as the basis for the authentication and delivery of 1941 Mortgage Bonds, the withdrawal of cash or the release of Funded Property) after deducting the amount of Property Retirements not previously deducted (net of cash, obligations and other property delivered to the 1941 Mortgage Trustee in connection with such Property Retirements).

Retired Bonds means 1941 Mortgage Bonds which have been retired (but not by use of certain cash proceeds including proceeds of the release of or insurance on Funded Property) and have not theretofore been used for any purpose under the 1941 Mortgage.

b. Net Earnings Test

In general, the issuance of 1941 Mortgage Bonds is subject to the delivery to the 1941 Mortgage Trustee of a Net Earnings Certificate showing net earnings of the Company for 12 consecutive months within the preceding 15 months to be at least two times the annual interest requirements on all 1941 Mortgage Bonds at the time Outstanding (except any to be retired in connection with the new issue), new 1941 Mortgage Bonds then applied for and all other indebtedness (with certain exceptions) secured by a lien prior to the lien of the 1941 Mortgage. Net earnings are calculated before, among other things, provisions for income taxes. The calculation of net earnings also does not take into account profits or losses from the sale or disposal of capital assets or securities, and, for purposes of the Net Earnings Certificate, not more than 15% of net earnings may consist of net nonoperating income and/or net operating revenue from sources other than the Utility Business.

The Company is not required to deliver a Net Earnings Certificate prior to issuance of 1941 Mortgage Bonds on the basis of Retired Bonds unless: i) the new 1941 Mortgage Bonds are issued within one year after the issuance of, or more than two years prior to the stated maturity of, the Retired Bonds and the new 1941 Mortgage Bonds bear a greater rate of interest than such Retired Bonds; or ii) the new 1941 Mortgage Bonds are issued in respect of Retired Bonds the interest charges on which have been excluded from any Net Earnings Certificate filed with the 1941 Mortgage Trustee since the retirement of such 1941 Mortgage Bonds.

c. 1941 Mortgage Bonds Issuable

As of May 31, 1998, the amount of Net Property Additions, as recorded at Cost, available to be used as the basis for the authentication and delivery of 1941 Mortgage Bonds was approximately $150 million; and as of July 15, 1998, the amount of Retired Bonds was $358 million. Substantially all such Net Property Additions and $50 million in Retired bonds were used to issue $140 million of First Collateral Trust Bonds on August 4, 1998. Following the scheduled redemption of $137 million of First Mortgage Bonds on September 3, 1998, the Company anticipates having a total of $444 million of Retired Bonds. Such Retired Bonds would permit, and the net earnings test would not prohibit, the authentication and delivery of $444 million in aggregate principal amount of 1941 Mortgage Bonds at an assumed interest rate of 7.5% per annum.

Net Property Additions and Retired Bonds may also be made the basis of the withdrawal of cash deposited in connection with the release of property from the lien of the 1941 Mortgage, as discussed in "Withdrawal of Cash."

4. Release of Property

Unless a Default has happened and is continuing, the Company may obtain the release from the lien of the 1941 Mortgage of any property (except for cash, obligations or other personal property held by the 1941 Mortgage Trustee) upon delivery to the 1941 Mortgage Trustee of, among other things, cash and purchase money obligations having an aggregate fair value at least equal to the fair value of the property to be released; provided, however, that the aggregate principal amount of such purchase money obligations will not exceed 66 2/3% of the fair value of such property; and provided, further, that the aggregate principal amount of purchase money obligations and governmental obligations delivered in connection with a taking of Company property by eminent domain at any one time held as part of the Trust Estate, shall not exceed 15% of the aggregate principal amount of 1941 Mortgage Bonds then Outstanding.

The 1941 Mortgage provides simplified procedures for the release of minor properties and property taken by eminent domain, and provides for dispositions of certain obsolete property and grants or surrender of certain rights without any release or consent by the 1941 Mortgage Trustee.

5. Withdrawal of Cash

Unless a Default has happened and has not been remedied, all or any part of the moneys received by the 1941 Mortgage Trustee in consideration of any release, including payments on account of purchase money obligations or governmental obligations so received, at the election of the Company, shall:

a. be withdrawn from time to time by the Company (i) in an amount equal to 166 2/3% of the principal amount of 1941 Mortgage Bonds to the authentication and delivery of which the Company is entitled on the basis of Net Property Additions and/or (ii) in an amount equal to the principal amount of 1941 Mortgage Bonds to the authentication and delivery of which the Company is entitled on the basis of Retired Bonds; or

b. be applied by the 1941 Mortgage Trustee to the purchase or redemption of 1941 Mortgage Bonds, as directed by the Company, but subject to the deposit by the Company of certain additional moneys to pay premium and accrued interest.

See "Issuance of Additional 1941 Mortgage Bonds - *1941 Mortgage Bonds Issuable*" for information regarding available Net Property Additions and Retired Bonds.

6. Modification of 1941 Mortgage

Without the consent of any holders of 1941 Mortgage Bonds, the Company and the 1941 Mortgage Trustee may enter into one or more supplemental indentures to correct defective or ambiguous provisions, to add collateral or covenants, to create series of bonds and for other similar purposes.

Except as provided above, any change or alteration of the 1941 Mortgage requires the consent of the holders of not less than 75% in principal amount of the 1941 Mortgage Bonds then Outstanding and of not less than 75% in principal amount of the Outstanding 1941 Mortgage Bonds of any one or more series which may be affected by any such modification differently from other series; except that, in certain cases, the consent of the holders of 100% in principal amount of the 1941 Mortgage Bonds then Outstanding is required.

7. Defaults

The 1941 Mortgage contains customary events of default relating to non-payment of principal or interest, failure to perform or observe covenants and certain events relating to bankruptcy or insolvency of the Company.

In addition, so long as the trustee under the 1998 Indenture holds 1941 Mortgage Bonds as Class A Bonds (as hereinafter defined), an event of default under the 1998 Indenture constitutes an event of default under the 1941 Mortgage.

8. Remedies

Upon the occurrence of a Default under the 1941 Mortgage, the 1941 Mortgage Trustee may, and upon the written request of the holders of a majority in aggregate principal amount of the 1941 Mortgage Bonds then Outstanding shall, by notice in writing given to the Company, declare the principal of all 1941 Mortgage Bonds then Outstanding and the interest accrued thereon, if any, immediately due and payable.

The 1941 Mortgage provides that, in case one or more Defaults have happened and have not been remedied, the Company, upon demand of the 1941 Mortgage Trustee, will forthwith surrender to the 1941 Mortgage Trustee possession of, and, to the extent permitted by law, the 1941 Mortgage Trustee, may enter and take possession of, the Trust Estate, and may use, operate, manage and control the same and conduct the business thereof or, with or without entry, may sell the same to the highest bidder. In case of any sale of the Trust Estate or any part thereof, whether made under power of sale or by virtue of judicial proceedings, the principal of and interest, if any, on all 1941 Mortgage Bonds then Outstanding, if not already due, will immediately become due and payable.

II. THE 1992 MORTGAGE

A. General

The 1992 Mortgage provides for the issuance thereunder of multiple series of bonds, as discussed below under "Issuance of Additional 1992 Mortgage Bonds". All bonds issued under the 1992 Mortgage are collectively referred to herein as the "1992 Mortgage Bonds". Capitalized terms used under this heading which are not otherwise defined herein have the meanings ascribed thereto in the 1992 Mortgage.

At the date hereof, \$441 million in aggregate principal amount of 1992 Mortgage Bonds are Outstanding. All of such 1992 Mortgage Bonds were issued and are held as collateral security for the obligations of the Company under the Credit Agreement, dated as of December 30, 1997 (the "Credit Agreement"), among the Company, the lenders party thereto, the issuing banks party thereto, the syndication and documentation agents thereunder and Toronto Dominion (Texas), Inc., as Administrative Agent. Letters of credit issued pursuant to the Credit Agreement secure \$328.6 million in aggregate principal amount of industrial development revenue bonds issued for the benefit of the Company (together with amounts in respect of accrued interest thereon). In addition, the Credit Agreement provides for a \$100 million revolving credit facility under which, at the date hereof, there were no borrowings outstanding.

B. Security

1. General

The 1992 Mortgage constitutes a lien on substantially all the real property and tangible personal property of the Company, other than property excepted from the lien thereof and such property as may have been released from the lien thereof in accordance with the terms thereof, subject to no liens prior to the lien of the 1992 Mortgage other than the lien of the 1941 Mortgage, other Permitted Encumbrances and certain other liens permitted to exist.

The 1992 Mortgage provides that after-acquired property (other than excepted property) will be subject to the lien of the 1992 Mortgage except in certain circumstances involving a consolidation, merger or similar transaction. In addition, after-acquired property may be subject to liens existing or placed thereon at the time of acquisition thereof, including, but not limited to, purchase money liens and, in certain circumstances, to liens attaching to such property prior to the recording and/or filing of an instrument specifically subjecting such property to the lien of the 1992 Mortgage.

Other than minor differences with respect to excepted property, the 1992 Mortgage is generally a lien on the same properties as the 1941 Mortgage.

2. Excepted Property

There are excepted from the lien of the 1992 Mortgage, among other things (a) bills, notes and accounts receivable, cash, choses in action, operating agreements and leases in which the Company is the lessor; (b) shares of stock, bonds and other securities (except those specifically subjected to such lien or required to be pledged); (c)(i) goods and merchandise acquired for the purpose of sale in the ordinary course of business; and fuel, materials, supplies and other personal property which are consumable in their use in the operation of, or are not in use in connection with or connected as fixtures to, the plants and systems of the Company; (ii) automobiles, buses, trucks, tractors, trailers and similar vehicles and rolling stock and other railroad equipment; and (iii) to the extent not properly chargeable to the utility plant accounts of the Company, hand tools, furniture, and computers, machinery and equipment used exclusively for corporate administrative or clerical purposes; and (d) the Company's franchise to be a corporation.

Properties held by subsidiaries of the Company, as well as properties leased from other Persons, are not subject to the lien of the 1992 Mortgage.

3. 1941 Mortgage

The lien of the 1992 Mortgage is junior, subject and subordinate to the lien of the 1941 Mortgage.

C. Issuance of Additional 1992 Mortgage Bonds

1. General

The aggregate principal amount of 1992 Mortgage Bonds which may be authenticated and delivered under the 1992 Mortgage is effectively unlimited. 1992 Mortgage Bonds of any series may be issued from time to time on the basis of, and in an aggregate principal amount not exceeding:

a. 70% of the Cost or fair value to the Company (whichever is less) of Net Property Additions (as described below) which do not constitute Funded Property;
b. the aggregate principal amount of Retired Bonds; and
c. an amount of cash deposited with the 1992 Mortgage Trustee.

Property Additions generally include any property which is properly chargeable to the utility plant accounts of the Company and is used or useful or to be used in the Utility Business. Net Property Additions means, generally, Property Additions (not theretofore funded by use as the basis for the authentication and delivery of 1992 Mortgage Bonds, the withdrawal of cash or the release of Funded Property) after deducting the amount of Property Retirements not previously deducted (net of cash, obligations and other property delivered to the 1992 Mortgage Trustee in connection with such Property Retirements).

Retired Bonds means 1992 Mortgage Bonds and 1941 Mortgage Bonds: i) which have been retired (but not by use of certain cash proceeds including proceeds of the release of or insurance on Funded Property); ii) which have not theretofore been used for any purpose under either of such mortgages; and iii) with respect to 1992 Mortgage Bonds retired prior to the first certification of Net Property Additions and to be used as Retired Bonds after such certification, which have been reflected in such certification and matched by an appropriate amount of Net Property Additions. 1941 Mortgage Bonds used as Retired Bonds under the 1992 Mortgage may not thereafter be used as such under the 1941 First Mortgage.

2. Net Earnings Test

In general, the issuance of 1992 Mortgage Bonds is subject to the delivery to the 1992 Mortgage Trustee of a Net Earnings Certificate showing net earnings of the Company for 12 consecutive months within the preceding 16 months to be at least 1 3/4 times the annual interest requirements on all 1992 Mortgage Bonds at the time Outstanding (except any to be retired in connection with the new issue), new 1992 Mortgage Bonds then applied for, all 1941 Mortgage Bonds then outstanding and all other indebtedness (with certain exceptions) secured by a lien prior to the lien of the 1992 Mortgage, except that no such net earnings requirement need be met if the additional 1992 Mortgage Bonds to be issued are not stated by their terms to bear simple interest. Net earnings are calculated before, among other things, provisions for income taxes; depreciation or amortization of property; interest and amortization of debt discount or expense; any non-recurring charge to income of whatever kind or nature (including without limitation the recognition of expense due to the non-recoverability of investment), whether or not recorded as a non-recurring item in the Company's books of account; and any refund of revenues previously collected or accrued by the Company subject to possible refund. The calculation of net earnings also does not take into account profits or losses from the sale or disposal of capital assets or securities or extraordinary items of any kind or nature, and for purposes of the net Earnings Certificate, not more than 20% of net earnings, may consist of net non-operating income and/or net operations revenue from sources other than the Utility Business.

The Company is not required to deliver a Net Earnings Certificate prior to issuance of 1992 Mortgage Bonds on the basis of Retired Bonds unless: i) the new 1992 Mortgage Bonds are issued within one year after the issuance of, or more than two years prior to the stated maturity of, the Retired Bonds and the new 1992 Mortgage Bonds bear a greater rate of interest than such Retired Bonds; or ii) the new 1992 Mortgage Bonds are issued in respect of Retired Bonds the interest charges on which have been excluded from any Net Earnings Certificate filed with the 1992 Mortgage Trustee since the retirement of such 1992 Mortgage Bonds. In general, the interest requirement with respect to variable interest rate indebtedness, if any, is determined with reference to the rate or rates in effect on the date immediately preceding such determination or the rate to be in effect upon initial authentication.

3. 1992 Mortgage Bonds Issuable

As of May 31, 1998, the amount of Net Property Additions, as recorded at cost, available to be used as the basis for the authentication and delivery of 1992 Mortgage Bonds was approximately $726 million (assuming that no 1992 Mortgage Bonds are issued on the basis of Retired Bonds, as set forth below, and that no additional 1941 Mortgage Bonds are issued). Following the August 1998 issuance of the $140 million of the First Collateral Trust Bonds and the scheduled redemption of $137 million of First Mortgage Bonds in September 1998, TEP anticipates having approximately $72 million of such Net Property Additions. Such Net Property Additions would permit, and the net earnings test would not prohibit, the authentication and delivery of approximately $504 million in aggregate principal amount of 1992 Mortgage Bonds at an assumed interest rate of 7.5% per annum. As of July 15, 1998, the amount of Retired 1992 Mortgage Bonds was $153 million and the amount of Retired 1941 Mortgage Bonds was $358 million. Following the August 1998 issuance of the $140 million of the First Collateral Trust Bonds and the scheduled redemption of $137 million of First Mortgage Bonds in September 1998, TEP anticipates having approximately $444 million of Retired 1941 Mortgage Bonds. Such Retired Bonds would permit (assuming that no 1992 Mortgage Bonds are issued on the basis of Net Property Additions, as set forth above, and that no additional 1941 Mortgage

Bonds are issued (on the basis of such assumption), and the net earnings test would not prohibit, the authentication and delivery of $511 million in aggregate principal amount of 1992 Mortgage Bonds at an assumed interest rate of 7.5% per annum.

Net Property Additions and Retired Bonds may also be made the basis of the withdrawal of cash deposited in connection with the release of property from the lien of the 1992 Mortgage, as discussed in "Withdrawal of Cash."

D. Release of Property

Unless a Default has happened and is continuing, the Company may obtain the release from the lien of the 1992 Mortgage of any property (except for cash, obligations or other personal property held by the 1992 Mortgage Trustee) upon delivery to the 1992 Mortgage Trustee of, among other things, cash and purchase money obligations having an aggregate fair value at least equal to the fair value of the property to be released; provided, however, that the aggregate principal amount of such purchase money obligations will not exceed 70% of the fair value of such property; and provided, further, that the aggregate principal amount of purchase money obligations and governmental obligations delivered in connection with a taking of Company property by eminent domain at any one time held as part of the Trust Estate, and/or the trust estate under the 1941 Mortgage, shall not exceed 15% of the sum of (x) the aggregate principal amount of 1992 Mortgage Bonds then Outstanding and (y) the aggregate principal amount of 1941 Mortgage Bonds then outstanding.

The 1992 Mortgage provides simplified procedures for the release of minor properties and property taken by eminent domain, and provides for dispositions of certain obsolete property and grants or surrender of certain rights without any release or consent by the 1992 Mortgage Trustee.

So long as the 1941 Mortgage is in effect, in lieu of other release provisions, unless a Default has happened and is continuing, the Company may in the alternative obtain the release from the lien of the 1992 Mortgage of any property (except cash, obligations or personal property held by the 1992 Mortgage Trustee) by delivery to the 1992 Mortgage Trustee of, among other things: i) a copy of the release of such property from the lien of the 1941 Mortgage; and ii) a certificate or receipt of the 1941 Mortgage Trustee stating that the cash constituting any part of the consideration received in payment for the property to be released is held by 1941 Mortgage Trustee under an irrevocable order of the Company directing 1941 Mortgage Trustee to pay over the same to the 1992 Mortgage Trustee if and to the extent that the Company shall become entitled to withdraw such cash from 1941 Mortgage Trustee on the basis of property additions, as contemplated in the 1941 Mortgage.

E. Withdrawal of Cash

Unless a Default has happened and has not been remedied, all or any part of the moneys received by the 1992 Mortgage Trustee in consideration of any release, including payments on account of purchase money obligations or governmental obligations so received, at the election of the Company, shall:

a. be withdrawn from time to time by the Company (i) in an amount equal to 10/7 of the principal amount of 1992 Mortgage Bonds to the authentication and delivery of which the Company is entitled on the basis of Net Property Additions and/or (ii) in an amount equal to the principal amount of 1992 Mortgage Bonds to the authentication and delivery of which the Company is entitled on the basis of Retired Bonds; or

b. be applied by the 1992 Mortgage Trustee to the purchase or redemption of 1992 Mortgage Bonds, as directed by the Company, but subject to the deposit by the Company of certain additional moneys to pay premium and accrued interest.

See "Issuance of Additional 1992 Mortgage Bonds — *1992 Mortgage Bonds Issuable*" for information regarding available Net Property Additions and Retired Bonds.

F. Modification of 1992 Mortgage

Without the consent of any Holders, the Company and the 1992 Mortgage Trustee may enter into one or more supplemental indentures to correct defective or ambiguous provisions, to add collateral or covenants, to create series of bonds and to make other changes which do not adversely affect the Holders in any material respect.

Except as provided above, with the consent of the Holders of not less than 60% in aggregate principal amount of the 1992 Mortgage Bonds of all series then Outstanding, considered as one class, the Company and the 1992 Mortgage Trustee may enter into one or more supplemental indentures for the purpose of adding any provisions to, or changing in any manner or eliminating any of the provisions of, the 1992 Mortgage; provided, however, that if there are 1992 Mortgage Bonds of more than one series Outstanding and if a proposed supplemental indenture directly affects the rights of the Holders of one or more, but less than all, of such series then the consent only of the Holders of 60% in aggregate principal amount of Outstanding 1992 Mortgage Bonds of all series so directly affected, considered as one class, will be required; and provided, further, that in certain cases, the consent of the Holders of 100% in principal amount of 1992 Mortgage Bonds is required.

G. Defaults

The 1992 Mortgage contains customary events of default relating to non-payment of principal or interest, failure to perform or observe covenants and certain events relating to bankruptcy or insolvency of the Company.

In addition, so long as the trustee under the 1998 Indenture holds 1992 Mortgage Bonds as Class A Bonds, an event of default under the 1998 Indenture constitutes an event of default under the 1992 Mortgage.

H. Remedies

Upon the occurrence of a Default under the 1992 Mortgage, the 1992 Mortgage Trustee may, and upon the written request of the Holders of a majority in aggregate principal amount of the 1992 Mortgage Bonds then Outstanding shall, by notice in writing given to the Company, declare the principal (or, in the case of a Discount Bond, such portion of the principal as may be specified in the terms thereof) of all 1992 Mortgage Bonds then Outstanding and the premium, if any, and interest accrued thereon, if any, immediately due and payable.

The 1992 Mortgage provides that, in case one or more Defaults have happened and have not been remedied, the Company, upon demand of the 1992 Mortgage Trustee, will forthwith surrender to the 1992 Mortgage Trustee possession of, and, to the extent permitted by law, the 1992 Mortgage Trustee, may enter and take possession of, the Trust Estate, and may use, operate, manage and control the same and conduct the business thereof or, with or without entry, may sell the same to the highest bidder. In case of any sale of the Trust Estate or any part thereof, whether made under power of sale or by virtue of judicial proceedings, the principal (or, in the case of a Discount Bond, such portion of the principal as may be specified in the terms thereof) of and premium, if any, and interest, if any, on all 1992 Mortgage Bonds then Outstanding, if not already due, will immediately become due and payable.

III. THE 1998 INDENTURE

A. General

The 1998 Indenture provides for the issuance thereunder of multiple series of debt securities. All debt securities issued under the 1998 Indenture are collectively referred to herein as the "Indenture Securities." Capitalized terms used under this heading which are not otherwise defined herein shall have the meanings ascribed thereto in the Indenture.

B. Security

1. General

The 1998 Indenture does not constitute a direct mortgage or other lien on properties of the Company. However, as described below, until the Collateral Release Date (as hereinafter defined) the Trustee will hold, for the benefit of the Holders of all Indenture Securities, Class A Bonds (as hereinafter defined) equal in aggregate principal amount to the Outstanding Indenture Securities. The Class A Bonds, in turn, will be secured by a first mortgage lien on substantially all the utility plant assets of the Company. See THE 1941 MORTGAGE and THE 1992 MORTGAGE. However, after the Collateral Release Date, the Indenture Securities will be unsecured and will rank *pari passu* with all other unsecured and unsubordinated indebtedness of the Company. As described under "Limitation on Secured Debt", after the Collateral Release Date the Indenture will impose a limitation on the issuance or assumption by the Company of Secured Debt (as hereinafter defined).

"*Class A Bonds*" means: i) as of any time while the 1941 Mortgage remains in effect, bonds or other obligations now or hereinafter issued under the 1941 Mortgage; and ii) as of any time after the 1941 Mortgage has been satisfied and discharged and while the 1992 Mortgage remains in effect, bonds or other obligations now or hereinafter issued under the 1992 Mortgage.

"*Class A Mortgage*" means either the 1941 Mortgage or the 1992 Mortgage;

2. Class A Bonds

Except as otherwise contemplated below under this heading and in circumstances involving a defeasance of Indenture Securities of one or more series, all Outstanding Indenture Securities, equally and ratably, will enjoy the benefit of Class A Bonds delivered to the Trustee as the basis for the authentication and delivery of an equal principal amount of Indenture Securities.

So long as the Collateral Release Date (as hereinafter defined) has not occurred, prior to the authentication and delivery of Indenture Securities of any series, the Company will issue a corresponding series of Class A Bonds. Such Class A Bonds will be delivered to, and registered in the name of, the Trustee or its nominee and will be owned and held by the Trustee, subject to the provisions of the Indenture, for the benefit of the Holders of all Indenture Securities Outstanding from time to time.

Any payment by the Company of principal of or premium or interest on the Class A Bonds delivered to and held by the Trustee will be applied by the Trustee to the payment of any principal, premium or interest, as the case may be, in respect of the Indenture Securities which is then due and, to the extent of such payment, the obligation of the Company under the Indenture to make such payment in respect of the Indenture Securities will be deemed satisfied and discharged. Any payment by the Company of principal of or premium or interest on Indenture Securities authenticated and delivered on the basis of the delivery to the Trustee of Class A Bonds (other than by application of the proceeds of a payment in respect of such Class A Bonds) will, to the extent thereof, be deemed to satisfy and discharge the obligation of the Company, if any, to make a payment of principal, premium or interest, as the case may be, in respect of such Class A Bonds which is then due.

The Trustee may not sell, assign or otherwise transfer any Class A Bonds except to a successor trustee under the Indenture. At the time any Indenture Securities which have been authenticated and delivered upon the basis of Class A Bonds cease to be outstanding (other than as a result of the application of the proceeds of the payment or redemption of such Class A

Bonds), and upon the satisfaction of certain conditions, the Trustee will surrender to, or upon the order of, the Company an equal principal amount of such Class A Bonds having the same Stated Maturity and mandatory redemption provisions as such Indenture Securities.

3. Release of Class A Bonds

When no Class A Bonds are outstanding under a Class A Mortgage except for Class A Bonds delivered to and held by the Trustee, then, at the request of the Company and subject to the satisfaction of certain conditions, the Trustee will surrender such Class A Bonds for cancellation, the related Class A Mortgage will be satisfied and discharged and the lien of such Class A Mortgage on the Company's property subject thereto will cease to exist; provided, however, if, at the time of any such surrender of Class A Bonds outstanding under the 1941 Mortgage, any Class A Bonds are outstanding under the 1992 Mortgage, the Company will deliver to the Trustee Class A Bonds outstanding under the 1992 Mortgage in the same aggregate principal amount or amounts, bearing interest at the same rate or rates and having the same Stated Maturity or Maturities as the Class A Bonds to be surrendered.

On and after the date on which the Trustee surrenders all Class A Bonds then held by it as contemplated in the preceding paragraph without any new Class A Bonds being delivered in substitution therefor (such date being sometimes herein called the "Collateral Release Date"), the Indenture Securities will be unsecured obligations of the Company and will rank *pari passu* with all other unsecured and unsubordinated indebtedness of the Company. However, on and after the Collateral Release Date, the Indenture will impose limitations on the issuance or assumption by the Company of Secured Debt. See "Limitation on Secured Debt."

C. Limitation on Secured Debt

The 1998 Indenture provides that, on and after the Collateral Release Date, the Company will not create, issue, incur or assume any Secured Debt other than Permitted Secured Debt without the consent of the Holders of a majority in principal amount of the Outstanding Indenture Securities of all series and Tranches, considered as one class; provided, however, that the foregoing covenant will not prohibit the creation, issuance, incurrence or assumption of any Secured Debt if either: i) the Company shall make effective provision whereby all Indenture Securities then Outstanding will be secured equally and ratably with such Secured Debt; or ii) the Company delivers to the Trustee bonds, notes or other evidences of indebtedness secured by the Lien (as hereinafter defined) which secures such Secured Debt in an aggregate principal amount equal to the aggregate principal amount of the Indenture Securities then Outstanding and meeting certain other requirements set forth in the Indenture.

D. Modification of Indenture

Without the consent of any Holders of Indenture Securities, the Company and the Trustee may enter into one or more supplemental indentures to correct defective or ambiguous provisions, to add collateral or covenants, to create series of Indenture Securities and to make other changes which do not adversely affect the Holders in any material respect.

Except as provided above, the consent of the Holders of a majority in aggregate principal amount of the Indenture Securities of all series then Outstanding, considered as one class, is required for the purpose of adding any provisions to, or changing in any manner, or eliminating any of the provisions of, the Indenture pursuant to one or more supplemental indentures; provided, however, that if less than all of the series of Indenture Securities Outstanding are directly affected by a proposed supplemental indenture, then the consent only of the Holders of a majority in aggregate principal amount of Outstanding Indenture Securities of all series so directly affected, considered as one class, will be required; and provided, further, that in certain cases, the consent of the Holders of 100% in principal amount of Indenture Securities is required.

E. Events of Default

The 1998 Indenture contains customary events of default relating to non-payment of principal or interest, failure to perform or observe covenants and certain events relating to bankruptcy or insolvency of the Company.

In addition, so long as the trustee under the 1998 Indenture holds any Class A Bonds, an event of default under the related Class A Mortgage constitutes an event of default under the 1998 Indenture.

F. Remedies

If an Event of Default occurs and is continuing, then either the Trustee or the Holders of not less than 33% in aggregate principal amount of the Indenture Securities then Outstanding may declare the principal amount (or if any of the Indenture Securities are Discount Securities, such portion of the principal amount thereof as may be specified in the terms thereof) of all of such Indenture Securities, together with premium, if any, and accrued interest, if any, thereon, to be due and payable immediately by written notice to the Company (and to the Trustee if given by the Holders of Indenture Securities).

In addition to other remedies, the Trustee, as holder of Class A Bonds, may exercise any right or remedy available under the related Class A Mortgage.

<u>Schedule 3</u>

Estimate of Unmitigated Stranded Costs

This information is Confidential

and will be provided

pursuant to the terms of

Tucson Electric Power Company's

Protective Agreement

Schedule 4

Example of Computation of Final CTC Charge

The following is an example only, using the Company's assumptions set forth in Case 2 of Schedule 3. Assuming the kWh sales forecasted for 2001-2008, the resulting average CTC is approximately 1.8 cents on a per kWh basis.

	% Capital	Cost	Wtd. Cost	Pre-Tax Cost
Debt	65.00%	6.10%	3.97%	3.97%
Equity	35.00%	10.50%	3.68%	6.16%
			7.64%	10.13%

	Unamortized Balance of Stranded Costs	Amortization	Return & Taxes	Total Revenue Requirement	Forecasted kWh
1 **2001**	$821,000,000	62,839,114	$83,159,409	$145,998,523	8,013,300,000
2 **2002**	758,160,886	71,978,084	76,794,411	148,772,495	8,171,900,000
3 **2003**	686,182,802	82,095,450	69,503,723	151,599,173	8,327,500,000
4 **2004**	604,087,353	93,291,314	61,188,243	154,479,557	8,488,100,000
5 **2005**	510,796,039	105,675,939	51,738,730	157,414,668	8,643,600,000
6 **2006**	405,120,100	119,370,775	41,034,773	160,405,547	8,805,400,000
7 **2007**	285,749,325	134,509,592	28,943,660	163,453,253	8,951,600,000
8 **2008**	151,239,733	151,239,733	15,319,131	166,558,864	9,105,300,000
	TOTAL	$821,000,000	$427,682,081	$1,248,682,081	68,506,700,000

Schedule 5

Original Cost and Book Value of Generating Assets

The original cost and depreciated book value of the generating resources that are the subject of this Application are as follows[1]:

Plant	*Unit*	*Ownership Share*	*Original Cost ($ millions)*	*Net Book Value ($ millions)*
Springerville Station	1	100.0	$ 51	$ 37
Springerville Station	2	100.0	465	347
San Juan Station	1	50.0	148	39
San Juan Station	2	50.0	153	46
San Juan Step-Up Transformer		100.0	2	1
Navajo Station	1	7.5	35	21
Navajo Station	2	7.5	36	22
Navajo Station	3	7.5	47	30
Four Corners Station	4	7.0	42	11
Four Corners Station	5	7.0	38	10
Irvington Station	1	100.0	30	9
Irvington Station	2	100.0	29	10
Irvington Station	3	100.0	24	7
Irvington Station	4	100.0	12	7
Other		100.0	16	0
Intangible Plant	*	100.0	9	5
Unallocated General Plant	**	100.0	46	29
Total			$1,183	$631

Note: the above balances include General Plant and CWIP that are specifically identified with a generating facility. In addition, common utility plant and general plant associated with each location was allocated to each unit based on the total number of units for that location. A portion of the balances for Intangible Plant, Unallocated General Plant and the remaining CWIP may need to be allocated to Generation.

* *Intangible Plant is composed primarily of software costs for the mainframe and PC's.*

** *Unallocated General Plant is composed primarily of the following:*

- *Account 390 – Structures and Improvements*
- *Account 391 – Office Furniture and Equipment*
- *Account 394 – Tools, Shop and Garage Equipment*
- *Account 395 – Laboratory Equipment*
- *Account 397 – Communication Equipment*

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[1] Original Cost and Book Values of Generating Assets as of December 31, 1997

Property Under Capital Leases	Leased Asset - Original Cost ($ millions)	Leased Asset – Net Book Value ($ millions)
Irvington Unit 4	$ 137	$ 112
Springerville Unit 1	427	411
Springerville Unit 1 Allowance	(168)	(168)
Springerville Common	130	119
Springerville Coal Handling Facilities	189	174
Railroad Cars	3	3
Total	$ 718	$ 651

Note: the Gas Turbine Leases expired May 31, 1998 and are excluded.

Regulatory Assets & Liabilities		Net Book Value ($ millions)	ACC Decision
Springerville Coal Contract Termination Fee		$ 48	Interim Accounting Order dated 7/29/97
Deferred Springerville Unit 2 Costs		12	#59594, #57586, #58497
Deferred Springerville Common Facility Costs		58	#53260
Deferred Lease Expense		(32)	#58497
Springerville Coal Handling Facilities Deferred Lease Expense – amortization of 1/1/93 balance		44	#56659
Springerville Coal Handling Lease - Capital Gain Tax		3	#56659
Income Taxes Recoverable Through Future Rates	*	80	#56659
Unamortized (Gain)/Loss – Reacquired Debt	*	4	Past rate case treatment
Excess Capacity Deferrals	**	89	#58497, #59594
Total		$306	

* *Balance represents the portion allocated to generation and may require adjustment.*
** *The Excess Capacity Deferrals, while deferred for regulatory purposes, were not deferred for financial reporting purposes..*

The original cost and depreciated book value of the generating resources that are the subject of this Application are as follows[2]:

Plant	***Unit***	***Ownership Share***	***Original Cost ($ millions)***	***Net Book Value ($ millions)***
Springerville Station	1	100.0	$ 51	$ 37
Springerville Station	2	100.0	465	347
San Juan Station	1	50.0	148	39
San Juan Station	2	50.0	153	46
San Juan Step-Up Transformer		100.0	2	1
Navajo Station	1	7.5	35	21
Navajo Station	2	7.5	36	22
Navajo Station	3	7.5	47	30
Four Corners Station	4	7.0	42	11
Four Corners Station	5	7.0	38	10
Irvington Station	1	100.0	30	9
Irvington Station	2	100.0	29	10
Irvington Station	3	100.0	24	7
Irvington Station	4	100.0	12	7
Other		100.0	16	0
Intangible Plant	*	100.0	9	5
Unallocated General Plant	**	100.0	46	29
Total			$1,183	$631

Note: the above balances include General Plant and CWIP that are specifically identified with a generating facility. In addition, common utility plant and general plant associated with each location was allocated to each unit based on the total number of units for that location. A portion of the balances for Intangible Plant, Unallocated General Plant and the remaining CWIP may need to be allocated to Generation.

* *Intangible Plant is composed primarily of software costs for the mainframe and PC's.*

** *Unallocated General Plant is composed primarily of the following:*

- *Account 390 – Structures and Improvements*
- *Account 391 – Office Furniture and Equipment*
- *Account 394 – Tools, Shop and Garage Equipment*
- *Account 395 – Laboratory Equipment*
- *Account 397 – Communication Equipment*

[2] Original Cost and Book Values of Generating Assets as of December 31, 1997

Property Under Capital Leases	*Leased Asset - Original Cost ($ millions)*	*Leased Asset – Net Book Value ($ millions)*
Irvington Unit 4	$ 137	$ 112
Springerville Unit 1	427	411
Springerville Unit 1 Allowance	(168)	(168)
Springerville Common	130	119
Springerville Coal Handling Facilities	189	174
Railroad Cars	3	3
Total	$ 718	$ 651

Note: the Gas Turbine Leases expired May 31, 1998 and are excluded.

Regulatory Assets & Liabilities		*Net Book Value ($ millions)*	*ACC Decision*
Springerville Coal Contract Termination Fee		$ 48	Interim Accounting Order dated 7/29/97
Deferred Springerville Unit 2 Costs		12	#59594, #57586, #58497
Deferred Springerville Common Facility Costs		58	#53260
Deferred Lease Expense		(32)	#58497
Springerville Coal Handling Facilities Deferred Lease Expense – amortization of 1/1/93 balance		44	#56659
Springerville Coal Handling Lease - Capital Gain Tax		3	#56659
Emission Allowances – Deferred Gain		(17)	Deferred based on expected rate treatment
Income Taxes Recoverable Through Future Rates	*	80	#56659
Unamortized (Gain)/Loss – Reacquired Debt	*	4	Past rate case treatment
Excess Capacity Deferrals	**	89	#58497, #59594
Total		$289	

* *Balance represents the portion allocated to generation and may require adjustment.*
** *The Excess Capacity Deferrals, while deferred for regulatory purposes, were not deferred for financial reporting purposes..*

Schedule 6

Waiver Of Commission Rules And Orders

Holding Company Conditions - Decision No. 60480, Attachment A

General

The conditions set forth in Decision No. 60480 were designed to address TEP as a vertically integrated utility on a going forward basis indefinitely and to provide safeguards to protect the utility and its customers. Since the Commission entered this Decision, the Commission has adopted the Competition Rules, which requires the disaggregation of the vertically integrated utility. The Rules also provide for affiliate transactions and compliance filings with the Commission. TEP's plan for divestiture and for stranded cost recovery, which is the subject of this Application, will dramatically change TEP and its capital structure. Therefore, TEP believes that the conditions set forth below are either unnecessary, inconsistent with the Rules or will put the Company at a competitive disadvantage entering the competitive market place.

Condition No. 2 – Allocation

This condition requires that the Holding Company, TEP and sister companies will charge the lower of fully allocated cost or market price whenever goods, products or services are sold/provided by the Holding Company or sister companies to TEP and the higher of fully allocated cost or market whenever TEP sells/provides non-tariffed goods, products or services to the Holding Company or sister companies. It also contains compliance items for annual transfers in excess of $500,000. These concepts, as well as other affiliate relationships and transactions and compliance requirements, are now set forth in the Affiliate Transaction Rules set forth in A.A.C. R14-2-1617. In light of the new Rule, the condition is now unnecessary.

Condition No. 12 –Annual and Quarterly Reports

This condition provides for the annual and quarterly reports of the Holding Company, TEP and sister companies on both a consolidated and individual-company basis. Although TEP has no objection to filing such reports on a consolidated basis, TEP believes that it is inappropriate to require such reports on an individual-company basis. First, such information would be proprietary and confidential and would have to be filed with the Commission on such basis. Second, it puts an additional burden on the Company not placed on its competitors. And finally, in light of the Affiliate Transaction Rules, such reports are unnecessary.

Condition No. 13 – Non-clerical Personnel Report

This condition requires that the Commission be furnished annually a report identifying any non-clerical TEP personnel moved to the Holding Company or its subsidiaries on a full time basis. This condition is now unnecessary in light of the Affiliate Transaction Rules set forth in A.A.C. R14-2-1617.

Condition No. 17 – Capitalization

This condition provides that the capitalization of the sister companies (debt and equity) may not exceed 30 percent of TEP's capitalization unless otherwise approved by the Commission. In light of the proposed divestiture, as well as the Rules' requirements that competitive services be conducted through unregulated affiliates, TEP's total capitalization will decline significantly. The Company's total capitalization will likely be less than $1 billion following divestiture and securitization. Consequently, retaining the 30 percent cap will severely limit the unregulated business growth prospects and the ability to diversify the portfolio of projects/companies. Furthermore, the existing cap would effectively prohibit a UniSource unregulated business from purchasing TEP's generation because the investment size would cause

UniSource to exceed the 30 percent limit. This restriction would contradict the intent of the Rules, which allows a TEP affiliate to purchase the generation assets of the Company. It also would put TEP at a severe competitive disadvantage in that its competitors do not have a similar restriction.

Condition No. 19 – Public Equity Issuances

This condition provides that through 2003, the following proceeds will be used to reduce TEP's debt or added to TEP's equity accounts: a) 60 percent of any public equity issuances by UniSource; b) two percent of the net after-tax profits attributable to the Holding Company's equity interest in sister companies; c) the two percent will be split 50 percent to reduce TEP's debt or added to TEP's equity accounts and 50 percent to directly lower rates. As TEP will be divested of generation, the capital structure of the UDC will be dramatically redefined. Also, since TEP will have a better opportunity to attain a reasonable capital structure with the successful implementation of divestiture and the securitization of Stranded Costs, there is no need to mandate a portion of UniSource equity issuances for TEP. For this same reason, the need to limit dividends (Condition No. 20) and to predetermine the capital structure of TEP (Condition No. 21) is unnecessary and inappropriate. TEP's level of equity capital which is impacted by dividends and equity contribution from UniSource is best managed and monitored by the regulation of TEP. Finally, reductions in TEP's standard offer rates will be provided pursuant to mechanisms determined under A.A.C. R14-2-1604.C. Therefore, there is no further need to mandate that one percent of the net after-tax profits attributable to the Holding Company's equity interest in sister companies be used to reduce TEP's rates.

Condition No. 20 – Dividends

This condition provides that until such time as TEP's equity ratio equals 37.5 percent of total capital, TEP will not issue dividends to UniSource which comprise more than 75 percent of TEP's earnings. TEP believes this condition is now unnecessary and inappropriate for the reasons set forth in Condition No. 19 above.

Condition No. 21 – Capital Structure

This condition provides that TEP will target a 37.5 percent equity ratio in its capital structure by December 31, 2000. If the capital structure is not attained and the equity ratio is less than 37.5 percent by that date, the Commission may set rates for TEP based upon its actual capital structure at that date rather than the hypothetical 37.54 equity/62.5 percent debt capitalization currently included in rates. TEP believes this condition is now unnecessary and inappropriate for the reasons set forth in Condition No. 19 above.

Condition No. 23 – Job Descriptions

This condition provides that UniSource, TEP and sister companies will maintain up-to-date job position descriptions which clearly delineate duties and responsibilities, will state whether the position can be expected to work for more than one entity, and if the position is at the UniSource level, whether the duties relate to corporate governance functions and whether the duties and responsibilities of the position benefit more than one subsidiary. In light of the adoption of the A.A.C. R14-2-1617, this condition is unnecessary and puts TEP at a competitive disadvantage by requiring something of the Company that is not required of its competitors.

Condition No. 25 – Time Sheets

This condition provides that all employees below the Vice President level, who work for more than one department or responsibility area who may be called upon to work for more than one entity, keep detailed time sheets on a "positive" basis. Officers at the Vice President and above level must keep time sheets on an "exception" basis. It also provides that for future rate cases, if Staff finds the allocations unreasonable, there will be a rebuttable presumption that the resources of the employees should be allocated between regulated and unregulated activities in the same percentage as their respective percentage of capital investments.

With respect to the time sheets, in light of the adoption of the A.A.C. R14-2-1617, this condition is unnecessary and puts TEP at a competitive disadvantage by requiring something of the Company that is not required of its competitors. On the issue of the allocations, for the reasons stated in Condition No. 19 above, this treatment is unnecessary and inappropriate.

Condition No. 26 – M&A Activity

This condition provides that all TEP and UniSource employee time spent on mergers, acquisitions and new business development will be tracked for below-the-line recording and/or assignment to the new business. TEP believes that it is inappropriate to apply this to TEP given the Rules' mandate to transfer competitive functions to affiliates. As this activity has now been *mandated* by the Commission, it is inappropriate for TEP to be required to track this below-the-line. Further, TEP will be filing a rate case after the divestiture wherein this issue would be more properly addressed.

Condition No. 27 – Annual Document Filing

This condition requires TEP to file an annual report identifying nine types of information relating to interrelationships between TEP, the Holding Company and sister companies (*i.e.*, joint marketing efforts, trademarks, royalty and license agreements, etc.). This information, as well as the safeguards that the condition provides, is now set forth in the Affiliate Transaction Rules.

Such report is not required of TEP's competitors and places an unnecessary administrative burden on the Company.

Condition No. 28 - Single Investment Limitation

This condition provides that UniSource (and the sister companies) will not invest an amount greater than $60 million in any single investment without Commission approval. This condition is inappropriate in a competitive environment given the Commission's mandate to divest of generation and conduct competitive functions in affiliates. This limitation would not apply to TEP's competitors and would put TEP at a disadvantage. (See also the reasons set forth in Condition No. 19 above.)

<u>Other Rules and Orders</u>

General

The rules and orders set forth below were designed for vertically integrated utilities. The adoption of the Competition Rules and the Company's Stranded Cost recovery plan, fundamentally changes the need to impose such requirements on TEP. Additionally, many of these requirements would put administrative burdens on TEP and put the Company at a competitive disadvantage vis-à-vis its competitors who do not have similar requirements.

A.A.C. R14-2-701, *et seq.* - Integrated Resource Planning Rules

TEP believes that as these rules apply only to four Affected Utilities, application of these rules to only these entities gives an unfair advantage to competitors. Further, all participants should adhere to such planning requirements. The Competition Rules currently provide for the funding of IRP programs through the Systems Benefits Charge and the Rules establish a Solar Portfolio Standard that augments, if not supercedes the supply requirements of the IRP rules. TEP believes that the IRP rules should be suspended and ultimately repealed in favor of amendments to the Competition Rules that will apply to all entities equally. Until that happens, TEP requests a waiver of the application of these rules to TEP.

A.A.C. R14-2-801, *et seq.* - Affiliate Interest Rules

TEP believes that as these rules apply only to the Affected Utilities, application of these rules to only these entities gives an unfair advantage to competitors. For example, TEP would not be able to use utility funds to invest in affiliates. However, the Competition Rules mandate the separation of all competitive functions into affiliates. Additionally, there are annual compliance filings for TEP and UniSource contained in these rules that would not apply to competitors. TEP believes that application of these rules with respect to compliance filings and those transactions necessary to comply with the Decision, the Competition Rules and this Plan, should be waived for TEP until such time the rules are amended to apply to all entities equally.

Decision No. 59594 - Cost Containment Report and Mid-Year DSM and Renewables Report

This requirement is set forth in TEP's last rate case settlement and envisions TEP as a vertically integrated utility. The settlement placed a moratorium on rate increases until 2000 with the requirement that TEP file each year a Cost Containment Report outlining cost savings efforts by the Company in the previous year. To the extent there were significant savings, those savings would be shared between customers and shareholders through rate reductions. Since this Decision was entered, the Competition Rules were adopted which will explore ways for TEP to provide rate decreases to standard offer customers in the future. Additionally, the divestiture of TEP's generation assets will significantly affect the financial structure of the Company. Finally, as set forth in the Application, upon divestiture, TEP will file a rate case to set distribution rates for the UDC. As the requirement for filing this report has been superceded by these intervening events, the requirement should be waived.

Decision No. 57586 – New Director Affiliate Transaction Report

This requirement comes from TEP's 1990 rate case following the filing of the bankruptcy petitions against TEP. Under this Decision, the Company is required to file a report detailing transactions and relationships that new TEP Board members had with TEP for a ten-year period. There are several reasons why the Company is requesting a waiver from this requirement. First, it applies only to TEP and does not apply to the Company's competitors. Second, since the Commission entered this Decision, it adopted Affiliated Interest Rules that TEP has operated under and the Company has demonstrated to the Commission through its actions and policies that the need for the filing of this report is no longer necessary. Third, the Commission granted TEP's Holding Company application that contains a condition relating to UniSource Board oversight over affiliate transactions. For these reasons, TEP believes that this requirement should be waived.

Decision No. 58316 - Investment Subsidiary Liquidation Report and Purchase Agreement Summary

This requirement comes from a 1993 decision relating to the liquidation of TEP's investment subsidiaries, TRI and SRI. TEP continues to liquidate such subsidiaries and has been filing reports with the Commission on such activities since 1993. Since that time, TEP has demonstrated that it is complying with the Commission's requirements in liquidating these subsidiaries in a manner that is consistent with the interest of the Company and its customers. Therefore, TEP should be relieved of the obligation to file these reports on a going forward basis as it enters the competitive market. TEP, therefore, requests a waiver from this requirement.

Decision No. 58497 - Avoided Cost Report

This annual report relates solely to establishing TEP's avoided cost. As avoided cost relates solely to generation, the filing of this report will have no relevance, as TEP will be divesting of its generation assets. TEP, therefore, requests a waiver from this requirement.

Decision No. 57090 - Time of Use Letters

This semi-annual filing is of the letters the Company sends time-of-use customers relating to the seasonal change in on-peak/off-peak hours. Although TEP will continue to send customers these letters while TEP continues to provide time-of-use rates to customers, it should not have to file such letters with the Commission as generation will be competitive and there is no requirement for other ESPs to file such letters. TEP, therefore, requests a waiver from this requirement.

Decision No. 56659 - Time of Use Report

This semi-annual filing relates to the Company's time-of-use rates. Although TEP will continue to provide time-of-use rates until such time that generation will be fully competitive, it should not have to file a report with the Commission, as there is no requirement for other ESPs to file such a report. TEP, therefore, requests a waiver from this requirement.

<u>Other Reports or Filings not Necessary Post-Divestiture</u>

The following reports all relate to TEP's ownership and operation of generating assets. Once TEP divests of its generating assets, the requirement of filing the following reports with the Commission should be waived:

- **Decision No. 56526 - Fuel & Performance Filing**
- **Decision No. 57924 - Interruptible Report**
- **Statistical Data on Generating Units**
- **Generating Unit Outage Report**