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MEMORANDUM

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TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

DATE: September 3, 2010

RE: SUPPLEMENTAL STAFF REPORT FOR UNS ELECTRIC, INC. AND UNS GAS, INC. APPLICATION FOR A FINANCING ORDER AUTHORIZING VARIOUS FINANCING TRANSACTIONS DOCKET NOS.: E-04204A-09-0582 AND G-04204A-09-0582.

Attached is Staff's supplemental report for UNS Electric, Inc. and UNS Gas, Inc.'s joint application requesting authorization for various financing transactions.

Staff continues to recommend approval of the alternative proposed in the UNS Electric, Inc. and UNS Gas, Inc. comments and objection to the Staff Report, Exhibit A.

Any party who wishes may file comments to the Staff response with the Commission's Docket Control by 4:00 p.m. on or before September 13, 2010.

SMO:PMC:tdp

Originator: Pedro M. Chaves

Arizona Corporation Commission
DOCKETED

SEP 3 2010

DOCKETED BY

Service List for: UNS Electric, Inc. and UNS Gas, Inc.
Docket Nos. E-04204A-09-0582 and G-04204A-09-0582

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**SUPPLEMENTAL STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

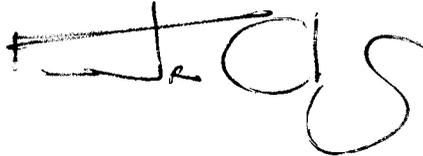
**UNS ELECTRIC, INC. and UNS GAS, INC.
DOCKET NOS. E-04204A-09-0582 & G-04204A-09-0582**

**APPLICATION FOR A FINANCING ORDER
AUTHORIZING VARIOUS FINANCING TRANSACTIONS**

SEPTEMBER 3, 2010

STAFF ACKNOWLEDGMENT

The supplemental Staff report for UNS Electric, Inc. and UNS Gas, Inc., Docket Nos. E-04204A-09-0582 and G-04204A-09-0582, respectively, is the responsibility of the Staff members listed below. Pedro M. Chaves is responsible for the financial review and analysis.

A handwritten signature in black ink, appearing to read 'P. M. Chaves', with a stylized flourish at the end.

Pedro M. Chaves
Public Utilities Analyst III

EXECUTIVE SUMMARY
UNS ELECTRIC, INC. AND UNS GAS, INC.
DOCKET NOS. E-04204A-09-0582 & G-04204A-09-0582

On August 30, 2010, the Hearing Division filed a procedural order ordering that Staff supplement its Staff Report with the pro forma analysis of the effect on the UNS Electric, Inc. ("UNS Electric") and UNS Gas, Inc. ("UNS Gas"), collectively ("Applicants") capital structure and an analysis of their abilities to service the proposed debt, or a statement of why such analysis is not possible or necessary in this case.

Under Staff's recommendation, the Applicants' ability to issue long-term debt is limited to certain equity-to-total capitalization (capital structure) and cash coverage ratio ("CCR") (ability to service debt) parameters.

Equity-to-total capitalization and CCR parameters are effective for placing conditions on debt issuances and can provide appropriate monitoring of indebtedness. In addition, the Applicants' proposal presents acceptable pro forma financial metrics that do not necessitate the imposition of the financial ratio tests to draws on the revolving credit facilities. Therefore, Staff concludes that an analysis of the pro forma effect on the Applicants' capital structure and an analysis of their abilities to service the proposed debt has been performed.

Staff continues to recommend approval of the alternative proposed in the UNS Electric, Inc. and UNS Gas, Inc. comments and objection to the Staff Report, Exhibit A.

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BACKGROUND

On December 29, 2009, UNS Electric, Inc. (“UNS Electric”) and UNS Gas, Inc. (“UNS Gas”), collectively (“Applicants”), filed a joint application with the Arizona Corporation Commission (“Commission”) requesting authorization of various financing transactions including: UNS Gas to refinance \$50 million of long-term debt maturing in August 2011; both entities to issue up to \$50 million of new long-term debt (in addition to the revolving credit facility); both entities to enter into revolving credit facility agreements with a combined \$100 million limit; pre-approved authority to subsequently refinance revolving credit facility agreements; and both entities to enter into security agreements granting liens on some or all of their properties.

On July 27, 2010, Staff filed a Staff Report concluding that the financing transactions proposed by the Applicants were reasonable, within their corporate powers, compatible with the public interest, would not impair their ability to provide services and would be consistent with sound financial practices if subsequent to any long-term debt issuance (other than in the case of refinancing long-term indebtedness) (1) common equity represents no less than 33 percent of total capital (common equity, preferred stock, capital leases - including current obligations, long-term debt - including current maturities) and (2) cash coverage ratio (“CCR”)¹ is equal to or greater than 1.75 when equity is between 33 and 40 percent of total capital or is equal to or greater than 1.25 when equity is 40 percent or higher of total capital (calculated using the most recent audited financial statements adjusted to reflect subsequent changes to outstanding debt and capital contributions or distributions).

On August 9, 2010, the Applicants filed comments and objections to the Staff Report. The Applicants requested approval of the initially-requested long-term debt and revolving credit facility authorizations and to exclude application of the financial ratio tests proposed by Staff to draws on the revolving credit facilities. In the alternative, the Applicants stated that it would be willing to agree to (1) limiting the amount that either borrowing entity could draw upon the proposed credit facilities to \$70 million; and (2) reducing the amount of additional long-term indebtedness that UNS Electric and UNS Gas would each be authorized to issue (other than refinancing) from the proposed \$50 million to \$30 million to avoid application of the financial ratio tests to draws on the revolving credit facilities.

On August 17, 2010, Staff updated its recommendations to reflect authorization for UNS Electric and UNS Gas to each issue up to \$30 million in additional long-term indebtedness and to limit each of the Applicants to draw a maximum of \$70 million from the revolving credit facility and to exclude application of the financial ratio tests proposed by Staff to draws on the revolving credit facilities.

¹ CCR provides a measure of a borrower’s ability to pay interest expenses with operating cash flow.

On August 30, 2010, the Hearing Division filed a procedural order ordering Staff to supplement its Staff Report with the pro forma analysis of the effect on the Applicants' capital structure and an analysis of their abilities to service the proposed debt, or a statement of why such analysis is not possible or necessary in this case.

FINANCIAL ANALYSIS

As indicated on the July 27, 2010, Staff Report, the general nature of the Applicants' requests calls for financial parameters to place conditions on the borrowings to prevent the Applicants from incurring an excessive amount of debt. As thresholds are ongoing in nature, the financial parameters employed as conditions for future borrowings must also be ongoing in nature. A combination of cash flow and balance sheet parameters is needed to provide a reasonably complete financial perspective.²

Under Staff's recommendation, the Applicants ability to issue long-term debt is limited to certain equity-to-total capitalization (capital structure) and cash coverage ratio ("CCR") (ability to service debt) parameters. Further, as indicated in Staff's response to the Applicants' comments,³ the Applicants' proposal presented acceptable pro forma financial metrics.⁴

CONCLUSIONS AND RECOMMENDATION

Equity-to-total capitalization and CCR parameters are effective for placing conditions on debt issuances and can provide appropriate monitoring of indebtedness. In addition, the Applicants' proposal presents acceptable pro forma financial metrics that do not necessitate imposition of the financial ratio tests to draws on the revolving credit facilities. Therefore, Staff concludes that an analysis of the pro forma effect on the Applicants' capital structure and an analysis of their abilities to service the proposed debt has been performed.

Staff continues to recommend approval of the alternative proposed in the UNS Electric, Inc. and UNS Gas, Inc. comments and objection to the Staff Report, Exhibit A.

² Staff Report, Page 5.

³ Staff's Response to the Applicants' comments, Page 4.

⁴ Additional confidential schedules not included in this public filing will be provided to the Administrative Law Judge.

SCHEDULE PMC-1 & PMC-2

REMOVED DUE TO
CONFIDENTIAL
INFORMATION