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IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. RE-00000C-94-0165 **TUCSON ELECTRIC POWER COMPANY'S EXCEPTIONS TO PROPOSED AMENDMENTS TO DECISION NO. 60977**

Tucson Electric Power Company ("TEP" or "Company"), through undersigned counsel, hereby submits the following Exceptions to the proposed amendments to Decision No. 60977 ("Proposed Amendments") filed by the Presiding Hearing Officer on February 5, 1999, in this docket.

INTRODUCTION

TEP, on previous occasions, has submitted to the Commission substantial evidence and legal analysis in support of its right to a legitimate opportunity for recovery of 100 percent of its stranded costs. See: TEP's Initial and Reply Briefs filed on March 16 and 23, 1998, respectively; and TEP's Exceptions to the Proposed Opinion and Order filed on May 29, 1998. TEP hereby incorporates by reference these prior submissions.

Although TEP supports the Proposed Amendments to the extent they purport to move the Commission away from "conditioning recovery of stranded costs upon forced divestiture," for the reasons set forth below, the Company still maintains that the Proposed Amendments will not provide Affected Utilities a reasonable opportunity to recover 100 percent of their stranded costs. Moreover, the Proposed Amendments ignore evidence in the record of the stranded cost proceeding and make a series of assumptions not supported by the record. While Decision No. 60977 states that the Affected Utilities should have a reasonable opportunity for 100 percent recovery of stranded costs, TEP does not believe that the Proposed Amendments will provide for such an opportunity.

Specifically, the Proposed Amendments fail to (a) provide a balance between the potential for mitigation, term of recovery and the impact of reduced/eliminated returns on Affected Utilities; (b) recognize the Affected Utilities' mitigation efforts to date; (c) factor each Affected Utility's specific opportunities for future mitigation; and (d) account for the fact that regulatory assets cannot be mitigated inasmuch as they are prior costs deferred by the *Commission* for future recovery. In addition, TEP believes that without any rate increases, it may take as long as ten (10) years to recover its stranded costs. Obviously, any rate decreases that would be ordered would lengthen the time period necessary to recover stranded costs. Again, the Proposed Amendments must consider and properly balance all of these factors in order to meaningfully provide the Affected Utilities with a real opportunity to recover 100 percent of their stranded costs.

Finally, the Company believes that the Commission's goal should be to approve for each Affected Utility a stranded cost recovery methodology that is in the best interests of all stakeholders. Therefore, the Commission should not be limited to Option Nos. 1, 2 or 3 when a combination of such options (absent a settlement) might be the optimal solution.

FINANCIAL ACCOUNTING STANDARDS CONSIDERATIONS

TEP is concerned that the options for stranded cost recovery, as set forth in the Proposed Amendments, do not comply with the accounting guidelines of the Statement of Financial Accounting Standard No. 71, *Accounting for the Effects of Certain Types of Regulation* ("FAS 71") and related accounting literature that applies to rate-regulated enterprises. Failure to meet the FAS 71 criteria in any material way would result in write-offs that would financially cripple the Company.

For recovery of the regulatory assets related to stranded costs to be recognized in the Affected Utilities' financial statements, the recovery paths must have the following characteristics:

- Cash flows must come from revenues derived from regulated rates, rather than competitive revenues, even if it is probable that such competitive revenues will be earned by the entity. The cash flows can come from (1) rates charged directly as a tariffed rate; (2) as a competitive transition charge; or (3) through proceeds from securitized bonds which will be paid off from regulated revenues. In addition, the cash flows need to be certain enough to warrant reliance upon them as a recovery mechanism. This certainty level should be interpreted as 80 percent (or better) probability of occurrence. The Accounting profession interpretations of FAS 71 requires that this certainty level be 80 percent (or better) probability of occurrence.

- Recovery of stranded costs must be not only relatively certain but also reasonably timely. Recovery periods of up to ten years *may* be considered adequately timely. However, considerable doubt exists as to whether recovery over a period in excess of ten years would be sufficiently timely. The longer the recovery period, the greater the need for a true-up mechanism to allow the utility's cost recovery to be re-evaluated and modified. In the alternative, a greater amount of "head room" within the rate, or other supporting evidence that the costs will be recovered by the end of the stated recovery period would be needed.

- A direct correlation between the costs incurred and the revenues being provided must exist. The financial viability measure as proposed in Option No. 3 would not satisfy this requirement. Setting rates, for example, based on a financial viability measure as proposed in Option No. 3 would be an approach to ratemaking based on factors other than cost-of-service.

A write-off of stranded costs would likely have a negative impact on the ability of the Company to conduct its business. A write-off to equity could cause TEP to default various credit agreements. In particular, TEP's bank credit agreement requires the Company to maintain a minimum level of common equity. As of December 31, 1998, the Company's equity balance was $230 million, which is only $47 million above the required minimum of $183 million. A default under the bank agreement could trigger cross defaults with other creditors and may increase the Company's cost of debt capital as lenders require a higher loan interest rate to compensate for the added TEP business risk and waiver of any default.

The Company's financial viability will also suffer if cash flows decline as a result of less than 100 percent recovery of stranded costs. The Company must maintain cash flows to meet existing payment obligations such as fuel, lease payments, interest and O&M costs. These liabilities do not change as a result of a writedown of asset values. Reduced cash flows may cause the Company's credit ratings to decline, which could increase TEP's debt costs. Lower cash flows would reduce the Company's ability to comply with other covenants contained in its bank credit agreement. In addition to the equity minimum described above, the credit agreement contains covenants relating to interest coverage and financial leverage, both of which are measured on cash flows available to the Company.

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RECOVERY METHODOLOGIES

TEP has analyzed each of the three stranded cost recovery methodologies set forth in the Proposed Amendments. TEP's analysis as presented herein addresses the financial and accounting implications of each methodology and proposes alternatives that, if adopted would render the methodologies feasible means for recovering stranded costs.

Option No. 1 – Net Revenues Lost Methodology

Again, despite Decision No. 60977's stated objective to provide the Affected Utilities a reasonable opportunity to recover 100 percent of their unmitigated stranded costs, the net revenues lost methodology, as set forth in the Proposed Amendments, will not accomplish this objective.

Generation Assets

The net revenues lost methodology outlined in the Proposed Amendments provides that customers who elect to participate in the competitive market will be obligated to pay a competitive transition charge ("CTC") equal to: a) 100 percent of stranded costs directly assignable in "year one"; b) 80 percent in "year two"; c) 60 percent in "year three"; d) 40 percent in "year four"; and e) 20 percent in year five, with no recovery thereafter. This 20 percent per year reduction does not provide an opportunity for the Affected Utilities to recover 100 percent of stranded costs. To justify this reduction, while taking the position that the option provides a reasonable opportunity for the Affected Utilities to collect 100 percent of their stranded costs, the Proposed Amendments state on page 3, line 1, that, "any shortfall the Affected Utility may have from the December 1998 customer base *could be more than made up from post 1998 customer growth.*" (Proposed Amendments at page 3, line 1; emphasis added.) This statement is <u>not</u> supported by any evidence in the record that indicates that Arizona (as a whole), or the service territory of any Affected Utilities, would have growth sufficient to support such reductions. Moreover, there is nothing in the record which quantitatively supports the supposition that the 20 percent annual CTC reductions are adequately recovered from customer growth. Also, the Proposed Amendments state that "any such growth would be considered as mitigation which the Affected Utilities can retain."(Id. at page 2. Line 20.) Once again, there is no quantification in the record to support the validity of this statement.

The only evidence of the growth rates appeared in the cross-examination of APS witness Jack Davis and of TEP witness Charles Bayless from the stranded cost proceeding. When asked about the growth rate in Arizona, Mr. Davis replied that, with respect to APS' system, it "is in the neighborhood of long-term about two to two and a half percent." (Reporters Transcript of Proceedings ("Tr.") at 3867.) When asked a similar question regarding the Tucson area, Mr. Bayless responded, "We're down in the one and a half to two. It varies up and down. It may hit three some years." (Tr. at 1675.) Therefore, it is clear that this option would not work the same for APS and TEP. It is also clear that growth in the range of those cited would be inadequate to support the 20 percent per year incremental reductions proposed.[1]

With 20 percent of customers in the first year and 100 percent of customers in the second year having access to the competitive market, the allocable portion of stranded cost at risk of non-recovery is high. The strong reliance on future growth or the presumption that many customers will choose to stay on the Standard Offer rates (which, in itself, is in conflict with the stated objective of the competition proceedings) does not provide TEP with a reasonable opportunity to recover stranded costs. The stranded cost amounts not recoverable through the more certain phased-in amounts would need to be estimated and written-off immediately due to FAS 71 requirements. Moreover, the decline in cash flows could reduce the Company's viability and its ability to comply with debt agreements as discussed above.

Regulatory Assets

Option No. 1 recognizes that "regulatory assets are more difficult for an Affected Utility to mitigate" but then reduces and ultimately eliminates the recovery of the return portion in order to encourage mitigation. The option provides that the regulatory assets would be recovered over their existing amortization periods, with a return on those assets phasing out over the first five years. In TEP's case, some of the regulatory assets have remaining amortization periods of 30 years. If the regulatory assets will not earn a return throughout the amortization period, the Company may have to immediately write-down the regulatory assets to their net present values. To avoid a write-down of the regulatory assets, the assets must earn a reasonable return. The return would include an equity component if earnings are to be maintained and equity is to continue to grow.

To summarize, it is not acceptable to write-off valid and prudently incurred costs due to failures to meet the requirements of FAS 71, which would then impair the Company's financial viability. This option must provide a strong "opportunity" (of 80 percent probability or higher) for

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[1] TEP's analysis of its stranded costs and recovery periods already contain a growth factor.

recovery of 100 percent of stranded costs (including generation assets, regulatory assets and at least an interest return thereon) over a period of not more than ten years through cash flows from regulated activities. Additionally, the CTC should be recoverable from all customers, including those customers under special contract.

Option No. 2 – Divestiture/Auction Methodology

The auction and divestiture method in the Proposed Amendments does not allow an opportunity for 100 percent recovery of stranded costs. It also lacks specificity. It does not offer an opportunity for 100 percent recovery as it provides no carrying charges over a ten-year recovery period and annual collections may potentially be reduced if an artificial rate cap is exceeded. The lack of carrying costs reduces recovery levels to 68 to 75 percent (assuming carrying costs of 7 to 10 percent). Accordingly, this would decrease the Company's financial viability and the likelihood of sustaining FAS 71 accounting. The level of recovery may be reduced further if stranded costs are deferred due to rate cap issues. This may be a significant problem over a ten-year recovery horizon as electric prices are expected to rise over that time frame. Further, TEP believes that a more precise definition of stranded cost is needed. Although any implementation plan will necessarily entail further definition through actual cost filings, for purposes of amendment to the option, TEP believes stranded costs should be defined as "the basis of the generation assets, less proceeds net of all costs, including taxes." Basis equals total cost (including all transaction costs) less previous disallowances.

The divestiture option must provide greater specificity regarding the type of costs that will be recoverable given the unique financial and ownership structure of the Company's generating assets. For example, the Company may have certain transaction costs and other payments to the lessors and debt participants. Any such payments must be explicitly included as elements of stranded costs. In addition, a significant portion of the Company's generating assets are financed with tax-exempt two-county debt. Such debt may have to be redeemed upon transfer of the assets. Similarly, costs associated with the transfer of the Company's fuel and transportation contracts and its interests in jointly-owned generating facilities must be taken into account in determining the costs associated with divestiture. Furthermore, all tax ramifications of a divestiture should be recoverable by the Affected Utility. Without recovery of the difference between the carrying amounts of generation assets and their market value, including the costs of divestiture, TEP would not agree to divest itself of those assets.

In order to complete the divestiture of its generating assets, the Company may be required to (1) redeem debt obligations associated with the assets, (2) compensate substitute lessees for assuming the Company's obligations under its leveraged leases, and/or (3) pay transaction costs payable to lessors, debt participants, fuel and transportation providers or participants in jointly-owned facilities, all as discussed previously. The cash required to make such payments may exceed the proceeds received by the Company from the divestiture of the assets. Consequently, funding would be required to finance the potential cash requirement.

The funds which may be required to effect divestiture could be obtained by the local distribution company (*i.e.*, TEP, upon divestiture) through one or more financings. The financing would be secured by the CTC the Company collects for its stranded costs. Lenders would look to the CTC cash payments as the source for the payment of interest and principal on the new loan(s). The loan terms (including the amount, interest rate and maturity) would be determined by the size and duration of the CTC and, of key importance, assurance that the CTC is an irrevocable obligation, subject to change only for true-up. One means of obtaining such assurance is through an order of the Commission, which must address the irrevocability of the CTC. To provide additional assurance and enhanced financing ability, the approved Commission order must clearly create a property right in the CTC (the "transition property") for the benefit of a special bankrupt-proof entity, independent of the Affected Utility. Bonds secured with such property rights could probably be issued by the special purpose entity on more favorable terms than the local distribution company would receive, thereby reducing costs to customers.

TEP also believes that, because it could take up to two years to complete the auction and divestiture of its generation assets, Option No.2 should provide for an interim CTC to commence with the introduction of competition to be paid by all non-standard offer customers. After divestiture and upon the setting of the permanent CTC, the amounts collected on an interim basis would be factored in.

The divestiture option states that it will provide 100 percent of stranded cost recovery over a period of ten years. However, Decision No. 60977 contradicts that intent by stating that the recovery is subject to a rate cap, uncollected amounts are to be deferred to future periods and no return is to be earned on the deferred balance. As with Option No. 1, the failure to have a return may result in an immediate write-down of assets to their net present value. In addition, there is no provision made for recovery of stranded cost amounts deferred beyond the ten-year period, which would not be collected due to the rate cap. The existence of the rate cap could preclude the recovery of a significant amount of stranded costs. The Affected Utility would be required to estimate the amount not expected to be recovered due to the rate cap and to write off that amount immediately.

The divestiture option must state that due to unforeseen circumstances, such as a higher than expected amount of stranded cost after divestiture or reduced levels of recovery resulting from the rate cap, the recovery period for the CTC may be extended by the Commission in order to provide for the opportunity for 100 percent recovery and to support any securitization. Finally, the option should provide that regulatory assets, together with a return thereon, are recoverable as part of the CTC or distribution charge, as appropriate.

The divestiture option also does not address the possibility that no acceptable bids will be received for the generating assets, or that the Commission does not approve a submitted divestiture plan or any portion thereof. Under such circumstances, the Affected Utility should have a reasonable opportunity for recovery of 100 percent of unmitigated stranded costs under a net revenues lost approach similar to Option No. 1 with TEP's proposed modifications.

Option No. 3 – Financial Integrity Methodology

This option is vague and needs considerably more specificity. Under the Arizona Constitution, the Commission has a legal obligation to prescribe just and reasonable rates and allow for a reasonable return on the fair value of a utility's property. This is a higher standard than minimum financial integrity. The option as proposed could be interpreted to mean that the Commission will provide sufficient revenues to provide one dollar over bankruptcy or sufficient revenues to meet financial obligations but will provide no return to shareholders. It could also require that Affected Utilities are provided adequate revenues to maintain investment grade ratings. This lack of clarity and specificity creates unacceptable risks to the Affected Utility.

This option states that the rates would be set to maintain the financial viability of the entity for a period of ten years and, thereafter, there would be no more stranded cost recovery. The option does not state how, or whether, stranded costs would actually be recovered. The method of recovery must be tied to the entity's costs incurred for it to be recognizable under FAS 71, and sufficient cash flows must be provided to maintain financial viability and avoid defaults. If recovery is provided through all the necessary cash flows, but such cash flows are derived from a method of ratemaking other than one that is cost-based, it will not be recognizable in the Affected Utilities' financial statements. TEP believes that this option should provide for sufficient revenues for an Affected Utility to reach and maintain, at a minimum, an investment grade credit rating, but through a cost-based revenue calculation collecting 100 percent of stranded cost so that FAS 71 write-offs do not result.

Option No. 4 – Settlement Methodology

This option provides for "some iteration/combination of Option Nos. 1, 2, or 3 which parties submit as a settlement option." TEP believes that this option should not be restricted only to a settlement. If an Affected Utility can demonstrate in its filing for stranded cost recovery (and at the hearing) that a plan that has a combination of Option Nos. 1, 2 or 3 has a result that is in the best interest of all stakeholders, there is no reason to limit the Affected Utility (and the Commission) to choosing one of the three options which may not achieve the same result.

CONCLUSION

Although TEP is supportive of bringing retail competition to Arizona as soon as practicable, the issues relating to stranded costs must be resolved prior to the advent of competition. The generic hearing which resulted in Decision No. 60977 was a necessary step toward providing guidance on those issues. While the Proposed Amendments attempt to balance the interests of all stakeholders, it omits critical details necessary to provide the Affected Utilities with a reasonable opportunity to recover 100 percent of their stranded costs, which may have significant financial and accounting implications to the Company. In the foregoing Exceptions, TEP has attempted to provide constructive and crucial comments that must be incorporated into the Proposed Amendments if they are to be adopted. At stake is the ability of the Commission to implement retail electric competition

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and the ultimate disposition of hundreds of millions of dollars of assets. The Company, therefore, urges the Commission to take into consideration and incorporate these Exceptions into the Proposed Amendments.

RESPECTFULLY SUBMITTED this 17th day of February, 1999.

TUCSON ELECTRIC POWER COMPANY

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