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BEFORE THE ARIZONA CORPORATION COMMISSION

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| IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR A FINANCING ORDER AUTHORIZING VARIOUS FINANCING TRANSACTIONS | DOCKET NO. E-01933A-12-0176<br><br>**APPLICATION FOR FINANCING ORDER** |

Tucson Electric Power Company ("TEP" or "Company"), through undersigned counsel, and pursuant to A.R.S. §§ 40-285, 40-301 and 40-302, hereby submits its Application for Financing Order ("Application") requesting that the Arizona Corporation Commission ("Commission") authorize TEP to enter into various financing transactions described more fully herein. The requested order would allow TEP to: (1) increase the cap on its long-term indebtedness from $1.3 billion to $1.7 billion; (2) increase the amount of revolving credit facilities from $200 million to $300 million; (3) increase the amount of authorized equity contributions from UNS Energy Corporation ("UNS Energy"), the parent company of TEP from $250 million to $400 million; (4) secure short-term debt issued pursuant to A.R.S. §40-302.D; and (5) extend the period to enter into these financings by two years to December 31, 2016.[1] As described more fully herein, TEP believes these authorizations are necessary at this time and are in the public interest. Additionally, the Company is seeking Commission approval of an interest rate hedging program for planned issuances of long-term debt. As described further in this application, TEP believes that such a program may provide a significant long-term benefit to customers in what is expected to be a rising interest rate

[1] TEP's current financing authority was granted in Decision No. 71788 (July 12, 2010).

environment. TEP further requests that the Commission approve this Application without a hearing and that such approval be granted prior to December 31, 2012.[2]

In support of this Application, TEP states as follows:

## I. BACKGROUND.

TEP is an Arizona public service corporation with its principal office and place of business in Tucson, Arizona. TEP owns and operates facilities for the generation, purchase, transmission, distribution, and sale of electricity in Tucson, the surrounding Pima County area, and to Fort Huachuca in Cochise County, Arizona. In addition, TEP owns interests in property in New Mexico in connection with the generation and transmission of electric power.

TEP is seeking to increase and extend its financing authority at this time for several reasons. First, by year-end 2012, the Company expects to have little room remaining under its current long-term debt cap of $1.3 billion. Based on a projected issuance of $130 million in new long-term debt during 2012, which will be needed to fund capital expenditures and to repay revolving credit borrowings, TEP will have less than $100 million of long-term debt issuance capacity left under its current financing authority. Second, the Company's forecast of required capital spending has increased significantly due to anticipated environmental upgrades at its coal-fired generating facilities, planned investments in renewable energy projects, and required upgrades to the Company's transmission and distribution facilities. Over the period 2012 – 2016, TEP expects that approximately $1.8 billion in capital expenditures will be required in order to maintain safe and reliable service to customers and to remain in compliance with new environmental regulations. Finally, the long-term lease arrangements covering Springerville Generating Station ("SGS") Unit 1 and the SGS coal handling facilities are scheduled to expire in January and April of 2015, respectively. As described in the Integrated Resource Plan submitted by TEP on April 2, 2012 in Docket No. E-00000A-11-0113, the Company believes that the purchase of SGS Unit 1 at the end of

[2] Given the anticipated timing for the commencement of the financing transactions described herein, TEP requests that this Application not be consolidated into the Company's upcoming rate case docket.

its current lease term would provide significant long-term benefits to retail customers. TEP's fair market value purchase option, which was recently determined pursuant to a formal appraisal procedure, is $159 million for the 86% of SGS Unit 1 owned by third-party investors. The fixed purchase price option for the SGS coal handling facilities, net of amounts expected to be paid by the owners of SGS Units 3 & 4, is $73 million. These expenditures by TEP would be in addition to the $1.8 billion of projected capital expenditures discussed above. Before TEP decides to exercise its purchase options for these facilities, decisions that must be made by September 1, 2013 for SGS Unit 1 and April 5, 2014 for the SGS coal handling facilities, respectively, the Company must ensure that it has sufficient financing authority to fund the purchases in 2015.

## II. <u>REQUESTED FINANCING AUTHORITY.</u>

In this Application, TEP requests authorization from the Commission to issue long-term debt, enter into credit facilities, receive additional equity contributions, and secure short-term debt as follows:

A. Issue additional long-term indebtedness and indebtedness to refinance existing long-term indebtedness, so long as after giving effect to the issuance of such indebtedness and the application of the proceeds thereof, the amount of outstanding long-term indebtedness (including current maturities thereof) of TEP shall not exceed $1,700,000,000 (which limit does not include capital lease obligations or indebtedness arising under TEP's credit facilities);

B. Enter into one or more credit or reimbursement agreements, and to enter into agreements to refinance any such credit or reimbursement agreements, which may consist of one or more revolving credit facilities, so long as after giving effect to the entry of such a facility, TEP's revolving credit facilities do not exceed $300 million in the aggregate, and to enter into one or more letter of credit facilities supporting tax-exempt bonds which have been or in the future will be issued pursuant to lawful authority;

C. Receive up to $400 million of additional equity contributions from its parent company, UNS Energy Corporation;

D. Secure short-term debt issued pursuant to A.R.S. §40-302.D with mortgage bonds issued under TEP's Mortgage and Deed of Trust;

E. Enter into these transactions on or before December 31, 2016; and

F. Permit any credit or reimbursement agreement, or any agreement to refinance any such credit or reimbursement agreement, entered into under lawful authority on or before December 31, 2016, to have a term of up to five years, and to remain valid through its final maturity date.

Within 90 days of the completion of any financing transaction made pursuant to the requested Commission Order, TEP would make a compliance filing with the Commission in which TEP would provide copies of the relevant agreements and provide a description of the business rationale for such financing or refinancing, including a demonstration that the rates and terms received by TEP were fair and reasonable under prevailing market conditions.

## III. <u>LONG-TERM DEBT.</u>

In Decision No. 71788, the Commission authorized TEP to issue long-term debt, provided that after issuance of such indebtedness, the aggregate outstanding principal amount of long-term indebtedness (including current maturities thereof) shall not exceed $1.3 billion (excluding existing capital lease obligations and indebtedness arising under credit and reimbursement agreements). As of March 31, 2012, TEP had total outstanding long-term indebtedness (excluding existing capital lease obligations and indebtedness arising under credit and reimbursement agreements) in an aggregate principal amount of $1.075 billion. Attached to this Application as **Exhibit A** is a schedule showing the individual series of debt which comprise this total and the maturity dates for each series.

TEP needs to increase its long-term debt cap to $1.7 billion to accommodate the financing of plant additions anticipated over the next several years. The plant additions are necessary in order for

TEP to continue to provide safe and reliable electrical service to its customers. Before year-end 2012, TEP expects to issue an additional $130 million in long-term debt to finance plant additions and to repay revolving credit borrowings. Once that debt is issued, TEP's balance of outstanding long-term debt will be $1.205 billion, leaving less than $100 million of available long-term debt issuance capacity under existing authority. Thus, TEP is requesting that the Commission increase its long-term debt cap to $1.7 billion, so that TEP can continue to provide cost effective, safe and reliable electrical service to its customers.

Over the next several years, TEP expects to enter into various long-term debt financing transactions. TEP anticipates that those transactions could include, without limitation, the following:

**A. Issuance of New Tax-Exempt Long-Term Debt.**

As a local furnishing utility, whose retail service area is confined to a contiguous two-county area, TEP has been able to finance a substantial portion of its utility plant assets with tax-exempt revenue bonds issued by governmental entities on TEP's behalf. If TEP wishes to cause to be issued new tax-exempt bonds, it must apply for a Private Activity Bond ("PAB") volume cap allocation from the State of Arizona. If TEP is awarded a PAB volume cap allocation, it may cause tax-exempt bonds to be issued for the local furnishing of electricity during the following three-year period. These tax-exempt local furnishing bonds, which would likely be issued by the Pima County Industrial Development Authority ("Pima Authority"), represent a potential source of financing for facilities serving retail customers in Pima and Cochise Counties. Most recently, TEP was awarded a PAB volume cap allocation in 2008, and in October 2010, the Company caused to be issued $100 million of 5.25% fixed-rate bonds maturing in 2040 through the Pima Authority. However, since interest on new private activity bonds is now subject to alternative minimum tax ("AMT") for federal income tax purposes, TEP does not have any near-term plans to apply for new PAB volume cap. Presently, there is a significant yield premium demanded by investors for new private activity bonds subject to the AMT.

TEP also has the ability to cause up to $150 million of tax-exempt bonds to be issued to refinance bonds it purchased and holds "in treasury". In December 2011, TEP purchased $150 million of its variable rate tax-exempt bonds with proceeds from a new taxable bond issuance. TEP chose not to retire these bonds, but instead, as owner of the bonds, they are held in treasury. TEP continues to pay interest on these bonds, and the interest is returned to TEP, as owner of the bonds, the same day. This allows TEP to maintain the tax-exempt status of the bonds to allow for future refinancing of the bonds. When TEP causes these bonds to be refinanced, the proceeds will go to TEP. Since the old bonds are held in treasury, they are not included on TEP's balance sheet and therefore are not included in the $1.075 billion in outstanding long-term debt reported as of March 31, 2012. When these bonds are refinanced, it will increase the amount of long-term indebtedness on TEP's balance sheet. TEP expects that interest on the new bonds would not be subject to AMT since the bonds held in treasury were originally issued in 1983 and 1985.

Decisions regarding the maturity date, interest rate (*e.g.* fixed vs. floating rate), security (*e.g.* whether to provide mortgage bonds as collateral), letter of credit support, and other key terms, would be subject to market conditions and other factors at the time of issuance. However, TEP's ability to finance on a tax-exempt basis will depend on the availability of PAB volume cap allocation (except in the case of the refinancing of the tax-exempt bonds held in treasury), will require continuing compliance with applicable tax laws and other requirements, and will be dependent on the state of the tax-exempt debt market.

**B. Issuance of New Taxable Long-Term Debt.**

In November 2011, TEP issued taxable long-term debt for the first time since 1998. Market conditions in the second half of 2011 were such that interest rates on taxable debt were comparable to rates on tax-exempt debt not subject to AMT, and significantly lower than rates on tax-exempt debt subject to AMT. TEP used this opportunity to issue $250 million of taxable unsecured 10-year notes at a rate of 5.15%. Proceeds of the issuance were used to repurchase $150 million of variable rate tax-exempt bonds described previously, redeem approximately $22 million of fixed rate bonds with a coupon of 6.10%, and repay $78 million on TEP's revolving credit facility.

TEP would like to retain the ability to issue long-term taxable corporate debt. Since any new tax-exempt bonds issued under a PAB allocation would be subject to AMT under current tax law, the taxable corporate bond market is a cost effective source of new long-term debt capital for TEP. Such taxable debt could be unsecured or secured, depending on market conditions and TEP's credit ratings, and could include mortgage bonds issued under TEP's Mortgage and Deed of Trust.

The variables to be determined prior to each issuance include maturity, interest rate, discount rates or placement fees, security, public vs. private offering and timing of issuance. These and other transaction-specific terms would be dependent on market conditions and would be negotiated with the intent of obtaining favorable terms to TEP.

**C. Refinancing of Long-Term Debt.**

As previously described, TEP had $1.075 billion of long-term debt outstanding as of March 31, 2012. Of this amount, approximately $215 million consisted of variable rate tax-exempt bonds. TEP has reduced its exposure to variable interest rate risk in recent years by refinancing variable-rate obligations on a fixed-rate basis. In addition, the Company entered into a fixed-for-floating interest rate swap agreement in 2009 that had the effect of fixing the rate on $50 million of variable-rate bonds. TEP plans to continue managing its exposure to variable interest rate risk through similar means over the next several years.

Additionally, TEP may have opportunities to refinance existing fixed-rate bonds to achieve a lower interest rate over the next several years. For example, TEP presently has $91 million of tax-exempt bonds bearing a fixed interest rate of 6.375% which may be redeemed at par in 2013. Based on current market conditions, it would be economical for TEP to pursue a refinancing of these bonds with new fixed-rate refunding bonds that would not be subject to AMT under current tax law. Alternatively, the Company could consider refinancing these bonds in the floating-rate tax-exempt market, and hedging a portion of the new bonds with an interest rate swap agreement if TEP's mix of fixed and floating-rate debt warranted such a hedge. Any refinancing of existing bonds would depend on market conditions and the terms available to TEP in both the taxable and tax-exempt bond markets. Decisions regarding the maturity date, interest rate (*e.g.* fixed vs. floating rate), security (*e.g.* whether to provide mortgage bonds as collateral), letter of credit support and other key terms would be subject to market conditions and other factors at the time of issuance.

## IV. CREDIT AND REIMBURSEMENT AGREEMENTS.

In Decision No. 71788, the Commission authorized TEP to enter into one or more credit or reimbursement agreements, and enter into agreements to refinance any such credit or reimbursement agreements, which may consist of one or more revolving credit facilities, so long as TEP's revolving credit facilities do not exceed $200 million in the aggregate, and that TEP may enter into one or more letter of credit facilities which provide letters of credit to support tax-exempt bonds which have been, or in the future will be, issued pursuant to lawful authority.

Under this authority, TEP amended its Credit Agreement dated August 11, 2006 ("Credit Agreement") in November 2010 to increase its revolving credit facility from $150 million to $200 million, and to extend the maturity of the revolving credit facility and its $341 million letter of credit ("LOC") facility from August 2011 to November 2014. In November 2011, TEP again amended its Credit Agreement to achieve lower pricing and to extend the maturity of its facilities to November 2016. In December 2011, TEP reduced the amount of its LOC facility from $341 million to $186 million as a result of the termination of three LOCs totaling $155 million. Termination of the LOCs was made possible by TEP's purchase of $150 million of variable rate tax-exempt bonds in late 2011.

Additionally, TEP entered into a $37 million letter of credit and reimbursement agreement to support the issuance of new variable rate tax-exempt bonds in 2010. As explained below, that agreement expires in December 2014.

The revolving credit facility under the Credit Agreement is used as a source of liquidity for seasonal working capital needs, for financing temporary balances of under-recovered fuel and purchased power costs, and for general corporate purposes. The revolving credit facility may also be used to issue letters of credit to provide credit enhancement to counterparties for TEP's energy procurement and hedging activities. TEP is requesting authorization to increase the aggregate size of its revolving credit facilities by up to $100 million to provide it with greater liquidity as TEP continues to grow, including the liquidity to support its commodity procurement and hedging activities. In light of recent volatility in the banking and credit markets, TEP believes it is also essential that it has financing authority in place to allow for a refinancing of its revolving credit and letter of credit facilities. Since the banking market currently supports terms of up to five years for new or amended credit facilities, TEP also requests that any new or amended credit facilities be allowed to have a term of up to five years.

### A. Existing Credit Agreement.

The Credit Agreement consists of two facilities: (a) a $200 million revolving credit facility and (b) a $186 million LOC facility. The credit facilities are secured by $386 million in mortgage bonds issued under TEP's Mortgage and Deed of Trust. Borrowings under the Revolving Credit Facility bear interest at a variable interest rate consisting of a spread over the London Interbank Offered Rate ("LIBOR") or an Alternate Base Rate (similar to a prime rate). The spread over LIBOR or Alternate Base Rate is determined based on a pricing grid that is, in turn, based upon the ratings of the credit facilities established by Standard and Poors ("S&P") and Moody's Investor Service ("Moody's"). The credit facilities are currently rated investment grade, BBB+ by S&P, and Baa1 by Moody's. As of March 31, 2012, the applicable borrowing rate for TEP was LIBOR plus 1.125%. TEP also pays a commitment fee of 0.125% on the unused portion of the revolving credit facility. As of March 31, 2012, TEP had $105 million in outstanding loans under its revolving credit facility at an average interest rate of 1.37%.

The LOC facility under the Credit Agreement provides $186 million of LOCs to support three series of TEP's tax-exempt variable rate debt obligations. The LOCs support $179 million aggregate principal amount of bonds and up to $7 million to cover varying number of days of accrued interest on such obligations. Fees payable on the LOC facility are also tied to the pricing grid that is based upon the ratings of the credit facilities. As of March 31, 2012, the applicable LOC fee was 1.125%. In addition, TEP pays an "LOC Fronting Fee" of 0.20% or 0.25% to the banks that are issuers of the LOCs.

**B. Existing LOC Reimbursement Agreement.**

In December 2010, under the general financing authority granted in Decision No. 71788, TEP caused the Coconino County Pollution Control Corporation to issue $36.7 million of variable rate tax-exempt bonds on its behalf. In connection therewith, a Reimbursement Agreement, dated December 2010 (the "LOC Reimbursement Agreement"), was entered into which consists of a $37.2 million letter of credit facility to provide credit support for the principal of the bonds and up to $0.5 million of accrued interest. The LOC Reimbursement Agreement is supported by $37.2 million of mortgage bonds issued under TEP's Mortgage and Deed of Trust. The LOC Reimbursement Agreement expires in December 2014. As of March 31, 2012, the applicable LOC fee under the LOC Reimbursement Agreement was 1.50%.

**C. Authority to Enter Into Credit or Reimbursement Agreements.**

As requested in this Application, TEP is seeking Commission authority to enter into one or more credit or reimbursement agreements and to enter into agreements to amend or refinance such credit or reimbursement agreements. Further, TEP is requesting that the Commission increase the authorized amount of revolving credit facilities from $200 million to up to $300 million in the aggregate. TEP may also need to refinance the LOC Reimbursement Agreement prior to its expiration in December 2014. The term of any new credit or reimbursement agreement or the length of any extension of the existing Credit Agreement or LOC Reimbursement Agreement would depend on market conditions at the time the new agreement or extension was executed but TEP would expect any such credit or reimbursement agreement to have a term of five years or less.

As was the case in Decision No. 71788, TEP does not propose to limit the amount of LOC facilities issued to support tax-exempt bonds to a specific amount because the tax-exempt bonds constitute a portion of TEP's authorized long-term debt issued pursuant to lawful authority. The

LOCs supporting such bonds represent a component of the tax-exempt debt financing arrangements which does not increase the amount of outstanding long-term debt of TEP but merely represents a cost effective method of providing credit support for such bonds. It is generally not possible to obtain LOCs with a maturity that matches the maturity of the bonds so renewals or replacements of such LOC facilities are periodically required to maintain such financings. TEP needs to renew or replace the LOC facilities in the Credit Agreement and LOC Reimbursement Agreement in order to maintain the current form of variable rate tax-exempt bonds supported by those LOCs. Also, if market conditions warrant, future issuances of tax-exempt bonds may be issued with LOC support which would require additional letter of credit facilities. The interest rates on all of TEP's variable rate tax-exempt bonds are currently reset weekly. As of March 31, 2012, the average variable interest rate on such bonds was 0.18% on an annualized basis.

## V. ADDITIONS TO TEP'S EQUITY CAPITAL.

Decision No. 71788 also ordered that "Tucson Electric Power Company is authorized to receive additional equity contributions of up to $250 million from UNS Energy Corporation for the purpose of augmenting its equity ratio as part of total capitalization." TEP is requesting in this Application the authority to obtain up to $400 million of additional equity contributions from its parent company over the next several years in order to maintain a balanced capital structure. TEP has worked hard over the years to improve and stabilize its capital structure. The reduction in debt leverage and improved capital structure has resulted in significant improvements in TEP's bond ratings by the major rating agencies (S&P, Moody's and Fitch Ratings ("Fitch")). These improvements allow TEP greater access to more favorably priced capital in the debt markets. Therefore, allowing TEP to obtain additional equity from its parent company in order to maintain a balanced capital structure is in the public interest.

## VI. SHORT-TERM DEBT ISSUED PURSUANT TO A.R.S. §40-302.D.

A.R.S. §40-302.D allows the Company to issue short-term debt in an amount not to exceed 7% of its capitalization without Commission approval. However, should the Company need to provide security for such short-term debt, possibly in the form of mortgage bonds issued under TEP's Mortgage and Deed of Trust, this would require Commission approval. Since the Company's revolving credit facility is currently secured by mortgage bonds, TEP believes that any additional short-term debt issued outside of its revolving credit facility would need to be secured in order to obtain reasonable terms on such debt. Therefore, in order for TEP to make cost effective use of the authority already granted by statute, TEP requests that the Commission allow the Company to secure short-term debt incurred pursuant to A.R.S. §40-302.D with mortgage bonds under its Mortgage and Deed of Trust.

It should be noted that borrowings under the Company's authorized revolving credit facilities are not considered short-term debt for purposes of A.R.S. §40-302.D since such borrowings are due upon the expiration date for the facilities, which can be up to five years from the date a facility is entered into. While TEP expects to rely on its authorized revolving credit facilities to meet its short-term liquidity needs, from time to time it may be advantageous or necessary for TEP to issue short-term debt pursuant to A.R.S §40-302.D without Commission approval. It is under such circumstances that TEP would like the ability to secure short-term borrowings with mortgage bonds as described above.

## VII. <u>REQUEST FOR EXTENSION OF TIME PERIOD.</u>

TEP requests that the Commission extend the time period to enter into the transactions mentioned above by two years, from the expiration date of December 31, 2014 under TEP's current financing order, to December 31, 2016. This extension of time would allow TEP to complete the financings required for the planned purchase of SGS Unit 1 and the SGS coal handling facilities at the end of their respective lease terms in 2015, and would allow TEP to refinance its existing revolving credit facility before it matures in November 2016. As previously described, TEP also requests that the Commission permit any credit or reimbursement agreement or any refinancing of such agreement entered into on or before December 31, 2016 to have a maturity date up to five years from the date such agreement was entered into or refinanced, but in no case extending beyond

December 31, 2021.

## VIII. USE OF PROCEEDS.

TEP intends to use the proceeds from the issuance of new long-term indebtedness for the following purposes: (i) refinance long-term indebtedness; (ii) finance a portion of TEP's capital expenditures; (iii) finance the purchase of SGS Unit 1 and SGS coal handling facilities; and (iv) pay-off outstanding borrowings under TEP's revolving credit facilities. TEP intends to use its revolving credit facility for the following purposes: (i) as a source of liquidity for working capital purposes; (ii) to issue letters of credit to provide credit enhancement to counterparties for TEP's energy procurement and hedging activities; and (iii) for other lawful corporate purposes.

Letter of credit facilities supporting variable rate tax-exempt bonds do not result in proceeds to TEP. Such facilities are for the purpose of providing credit support for tax-exempt bonds, the proceeds of which are used to finance capital expenditures of TEP.

## IX. TEP'S FINANCIAL CONDITION.

TEP's ratio of Total Equity to Total Capitalization (excluding capital lease obligations and short-term debt) has improved from 16% at December 31, 1998 to 43% at December 31, 2011. When TEP's net capital lease obligations are included, TEP's ratio of Total Equity to Total Capitalization has improved from 10% at December 31, 1998 to 36% at December 31, 2011. These improvements demonstrate the balanced approach that TEP has taken to improve its capital structure by ensuring that new long-term debt issuances are complemented with earnings retention and equity contributions from UNS Energy.

Attached as **Exhibit B** is a chart showing the trend in TEP's secured and unsecured bond ratings since 1996. As of the Application filing date, TEP's unsecured debt had investment-grade ratings of Baa3 from Moody's, BBB- from S&P and BBB- from Fitch. While this represents an improvement over previous years, these ratings represent the lowest investment-grade rating assigned by each agency. TEP plans to continue improving its balance sheet over time through retained earnings and equity contributions from its parent company.

The general financing authority granted to TEP in Decision No. 71788 was conditioned upon TEP having equity equal to at least 30% of its total capital (including capital lease obligations) and a cash coverage ratio of at least 1.75 times at the time of any new debt issuance (other than in the case of refinancing indebtedness). TEP adhered to this condition at the time of its new long-term debt issuances and will continue to agree to have this condition included in the general long-term indebtedness financing authority requested herein.

TEP believes that the amount of financing authority requested is reasonable and prudent and will not diminish TEP's financial integrity. TEP has made significant progress in reducing its leverage and improving its capital structure over the last 15 years and does not intend to re-leverage its balance sheet. The reduction in debt leverage and improved capital structure has resulted in significant improvements in TEP's bond ratings by the major rating agencies S&P, Moody's and Fitch.

## X. APPROVAL OF INTEREST RATE HEDGING PROGRAM FOR PLANNED ISSUANCES OF LONG-TERM DEBT.

With interest rates near all-time lows for investment-grade corporate borrowers, TEP believes it is an opportune time to consider an interest rate hedging program for planned issuances of taxable long-term debt. The forward market for interest rate swaps, which can be used to derive unbiased estimates of future spot rates, points toward a much higher interest rate environment in coming years. Since TEP expects to issue long-term debt to fund a substantial portion of its capital expenditure requirements over the next several years, the Company is proposing to implement an interest rate hedging program that is intended to produce long-term interest savings for the Company and its customers.

Interest rate hedging for new issuances of long-term debt is a common practice among electric utilities and other corporate borrowers with large financing needs. The most common practice is to enter into a forward-starting interest rate swap agreement or a U.S. Treasury rate-lock agreement with a highly rated financial institution. Both types of agreements are highly effective in hedging that portion of long-term debt cost that is tied to the benchmark U.S. Treasury rate. However, due to differences in liquidity between the LIBOR swap market and the U.S. Treasury market, it is more common to rely on forward starting LIBOR swaps to hedge interest rate risk for periods of six months or longer.

Regardless of whether a forward starting swap or a U.S. Treasury rate-lock is entered into, the mechanics and economic impact of such a hedge are nearly the same. In either circumstance, the Company would be entering into a derivative interest rate contract, the value of which will fluctuate with changes in either the forward swap market for 3-month LIBOR or the yield on U.S. Treasury bonds. At the time the long-term bonds or notes are issued, the value of the derivative contract would be settled in cash with the financial counter-party. From an economic perspective, this cash settlement can be viewed as either a premium or discount to the par value of the bonds or notes issued. Assuming the hedge qualifies for cash flow hedge accounting under Accounting Standards Codification 815 ("ASC 815"), the cash settlement would be accounted for similar to a cost of issuance (either positive or negative) and amortized over the term of the bonds or notes issued. In order to create a highly effective hedge that qualifies under ASC 815, the derivative contract would need to reference a swap or rate-lock period that closely matches the maturity date of the bonds or notes issued, and have a cash settlement date on or near the date of issuance.

As an example, if TEP were planning to issue $100 million of new fixed-rate 10-year taxable bonds in June of 2013, the Company would be exposed to interest rate volatility between now and the date of issuance. In order to hedge this risk, TEP could enter into a forward-starting 10-year LIBOR swap agreement with an effective date of June 2013 or later. Then on the bond issuance date, if the 10-year LIBOR swap rate had increased above the rate specified in the swap agreement, the swap agreement would be unwound and TEP would receive a cash settlement from the financial counter-party. The cash settlement would be based on the net present value of the difference between the market swap rate and the contractual swap rate applied to the notional amount of the hedge. From both an economic and financial accounting perspective, the cash settlement would be viewed as additional proceeds received from the sale of bonds, thus lowering the effective cost or yield-to-maturity of the bonds issued. By lowering the cost of debt in this manner, the hedge as described would serve to offset the increase in market interest rates that occurred between the hedge date and the bond issuance date.

Conversely, under this example, if market interest rates were to fall between the hedge date and the bond issuance date, the Company would have to pay cash to the financial counter-party in order to settle the swap agreement. Under this scenario, from both an economic and financial accounting perspective, the cash settlement would be viewed as a reduction in proceeds received from the sale of bonds, thus increasing the effective cost or yield-to-maturity of the bonds issued. However, this increased cost would simply serve to offset the reduction in market interest rates that occurred between the hedge date and the bond issuance date. Therefore, under either interest rate scenario, the hedge would serve to mitigate the impact of changes in market rates between the hedge date and the bond issuance date.

As demonstrated by this example, the purpose of a bond hedging program would be to mitigate the impact of fluctuating market rates on planned issuances of long-term debt. Over time, it is expected that some hedges would be "in the money" at settlement, while others would be "out of the money." However, in what is expected to be a rising interest rate environment over the next several years, implementation of an interest rate hedging strategy could result in savings to TEP and its customers over the long-run.

While TEP does not believe that interest rate swap agreements or U.S. Treasury rate-lock agreements represent an issuance of securities requiring Commission approval, the Company is seeking Commission approval of a hedging program for planned issuances of taxable long-term debt. Such an approval would be similar in concept to the review and approval by the Commission of energy procurement hedging programs in utility rate proceedings. Specifically, TEP requests Commission approval of an interest rate hedging program that contemplates hedging:

- up to 50% of the planned principal amount of any issuance of fixed-rate taxable long-term debt having a final maturity of five years or longer;

- up to 18 months in advance of the planned issuance date of the long-term debt; and
- through the use of one or more forward-starting interest rate swap agreements, U.S. Treasury rate-lock agreements, or other similar derivative interest rate contracts.

Additionally, TEP requests that the cash settlement of any such hedging contracts be treated as a cost of issuance (either positive or negative) when calculating the Company's cost of debt in future rate proceedings.

## XI. PUBLICATION OF NOTICE.

TEP will publish such notice of this Application as the Commission may require pursuant to A.R.S. §40-302.A. The notice will be substantially in the form attached hereto as **Exhibit C**. Proof of publication will be filed with the Commission once the notice is published.

## XII. NOTICE TO TEP.

All communications and correspondence regarding this Application, as well as communications and pleadings with respect hereto filed by other parties, should be served on the following:

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E-Mail: bcarroll@tep.com

## XIII. CONCLUSION.

TEP believes that Commission approval of this Application would provide TEP with the required flexibility to i) access the capital markets in a timely and efficient manner, ii) take advantage of selective opportunities to reduce TEP's financing costs, iii) manage the mix of fixed-rate and variable rate debt in TEP's capital structure, iv) select the appropriate financing options to match the purpose of the debt, and v) receive additional equity contributions from its parent to maintain a balanced capital structure. TEP believes that the financing authority requested herein is consistent with sound financial practices and its duties as a public service corporation, and is in the public interest

WHEREFORE, TEP respectfully requests that the Commission issue its Order in accordance with A.R.S. §§ 40-285, 40-301 and 40-302 as follows:

1. Finding and concluding that the approval of this Application is in the public interest;
2. Authorizing TEP to issue long-term indebtedness provided that after giving effect to the issuance of such indebtedness, the aggregate outstanding principal amount of long-term indebtedness of TEP (including current maturities thereof), shall not exceed $1.7 billion. Such limit does not include capital lease obligations, indebtedness arising under TEP's credit and reimbursement agreements and the principal amount of long-term debt being refinanced by newly issued debt being issued pursuant to such authority;
3. Authorizing TEP to enter into any refinancings, refundings, renewals, reissuances and rollovers of any outstanding indebtedness, as well as the incurrence or issuance of any additional long-term indebtedness, and the amendment or revision of any terms or provisions of or relating to any long-term indebtedness, so long as total long-term indebtedness outstanding, after giving effect to such issuance, does not exceed the levels set forth in (2) above;
4. Authorizing TEP to enter into one or more credit or reimbursement agreements with

terms of up to five years, and to enter into agreements to refinance any such credit or reimbursement agreements with new terms of up to five years, which may consist of one or more revolving credit facilities so long as, after giving effect to the entry of such a facility, TEP's revolving credit facilities do not exceed $300 million in the aggregate, and enter into one or more letter of credit facilities which provide letters of credit to support tax-exempt bonds which have been or in the future will be issued pursuant to lawful authority;

5. Authorizing TEP to provide security for any such financing transactions by the issuance of mortgage bonds under its Mortgage and Deed of Trust;

6. Authorizing TEP to secure short-term debt issued pursuant to A.R.S. §40-302.D with mortgage bonds under its Mortgage and Deed of Trust;

7. Authorizing TEP to receive additional equity contributions of up to $400 million from its parent, UNS Energy Corporation;

8. Requiring TEP, when refinancing long-term indebtedness under the authority set forth in (2) above in circumstances where the issuance of the refinancing debt would result in total long-term indebtedness exceeding the $1.7 billion level set forth in (2) above if the principal amount of the debt being refinanced were considered to be included in total long-term indebtedness, to repay the debt being refinanced within 90 days of the new debt issuance;

9. Conditioning the issuance of long-term indebtedness under the authority set forth in (2) above (other than in the case of refinancing long-term indebtedness) upon TEP having equity equal to at least 30 percent of its total capital and a cash coverage ratio of at least 1.75 when equity is between 30 and 40 percent of total capital, or a cash coverage ratio of 1.0 if equity is 40 percent or higher of total capital. The equity ratio and the cash coverage ratio shall be determined on a pro forma basis after giving effect to the issuance of the long-term debt to be issued pursuant to the authority and

the discharge of any long-term debt being refunded or refinanced thereby. For purposes of the Order, the equity ratio shall be the ratio of (a) common stock equity to (b) total capitalization, using the most recently audited financial statements as adjusted for capital contributions, distributions, and issuances, repayment or purchases of debt or equity occurring after the most recently audited financial statements. For the purposes of the Order, total capitalization shall be the defined as the sum of common stock equity, long-term debt (including current maturities thereof), capital lease obligations (including current obligations under capital leases), less TEP's investments in capital lease debt. For purposes of the Order, the cash coverage ratio shall be the ratio of (a) the sum of operating income, depreciation and amortization expense for the twelve month period ending on the last day of the period covered by the most recently audited financial statements, to (b) interest expense for the twelve month period ending on the last day of such period minus interest expense for such period for any indebtedness being refinanced or refunded with the proceeds of long-term debt being issued plus interest expenses for twelve months on the indebtedness being issued (calculated, in the case of indebtedness bearing a floating rate of interest, at the rate initially in effect on the date of the issuance thereof). For purposes of the Order, future changes in GAAP that have the effect of lowering TEP's equity will be exempted from the equity and cash coverage ratios tests until the Commission makes a determination. TEP shall make a filing with the Commission requesting such a determination within 30 days after the Company files its quarterly report on Form 10-Q or its annual report on Form 10-K with the Securities and Exchange Commission following the end of the fiscal quarter in which the GAAP change occurs. Incurring obligations under authorized credit or reimbursement agreements is not considered to be the incurrence of long-term indebtedness which is subject to the conditions set forth in this (8);

10. Authorizing the execution, delivery and performance by TEP of all contracts, agreements, and other instruments which are incidental to any or all of the foregoing or otherwise deemed by TEP to be necessary, desirable or appropriate in connection therewith;

11. Authorizing the issuance of long-term debt, and to enter into one or more credit agreements for revolving credit facilities and receive additional equity contributions in the Order shall replace the existing authorizations of Decision No. 71788, that those authorizations terminate upon the effective date of the Order, and that all existing obligations incurred under lawful authorizations shall remain valid;

12. Authorizing TEP to enter into the transactions authorized under the Order through December 31, 2016,

13. Permitting any credit or reimbursement agreement, or any agreement to refinance any such credit or reimbursement agreement, entered into under lawful authority on or before December 31, 2016, to remain valid through its final maturity date, which in any case shall not extend beyond December 31, 2021;

14. Approving the interest rate hedging program relating to planned issuances of long-term debt as described herein;

15. Finding that the financing described herein is reasonably necessary and appropriate for the purposes described in this Application and that such purposes are not, wholly or in part, reasonably chargeable to operating expenses or to income;

16. Authorizing TEP to pledge, mortgage, lien and/or encumber its real property;

17. Finding that the financing described herein is for lawful purposes within TEP's corporate powers, compatible with the public interest, with sound financing practices, and with proper performance by TEP of service as a public service corporation, and will not impair TEP's ability to perform the service; and

18. Granting any other relief that the Commission determines to be appropriate and in the public interest.

TEP further requests that the Commission issue its Order approving the Application by December 31, 2012, and that the Application be approved without a hearing.

RESPECTFULLY SUBMITTED this 15th day of May, 2012.

TUCSON ELECTRIC POWER COMPANY

By ______________________
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Attorneys for Tucson Electric Power Company

Original and 13 copies of the foregoing
filed this 15th day of May 2012, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copy of the foregoing hand-delivered this 15th day of May 2012, to:

Lyn Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Janice M. Alward
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Phoenix, Arizona 85007

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Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

By Mary Ippolito

# EXHIBIT

# "A"

# TUCSON ELECTRIC POWER COMPANY
## LONG-TERM DEBT AT 3/31/12

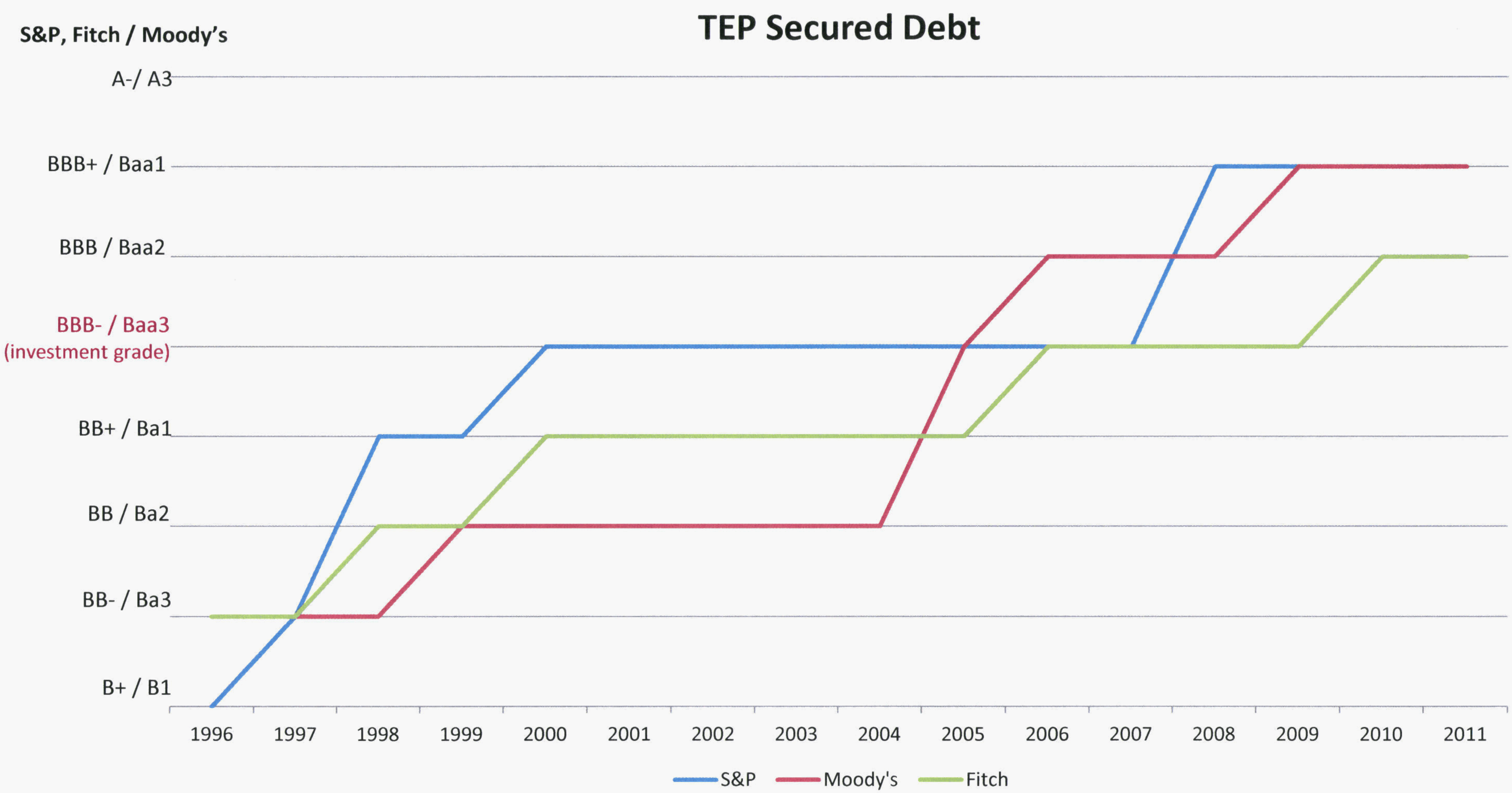
| | AMOUNT OUTSTANDING ($MILLIONS) | INTEREST RATE AT 3/31/2012 | DATE ISSUED | DUE DATE | FIRST CALL DATE AT PAR | SECURITY PROVIDED | LETTER OF CREDIT EXPIRATION | FACILITIES FINANCED |
|---|---|---|---|---|---|---|---|---|
| TAXABLE BONDS (FIXED RATE) | | | | | | | | |
| 2011 Unsecured Notes | $250.00 | 5.15% | 11/11 | 11/21 | 8/21 | Unsecured | N/A | General corporate purposes |
| TAX-EXEMPT BONDS (FIXED RATE) | | | | | | | | |
| 1998 Apache A | $6.89 | 5.850% | 3/98 | 3/28 | Anytime | Unsecured | N/A | Local T&D |
| 1998 Apache B | $8.22 | 5.875% | 3/98 | 3/33 | Anytime | Unsecured | N/A | Local T&D |
| 1998 Apache C | $1.36 | 5.850% | 3/98 | 3/26 | Anytime | Unsecured | N/A | Local T&D |
| 2008 Pima A | $90.75 | 6.375% | 3/08 | 9/29 | 3/13 | Unsecured | N/A | SGS Express Line / Local T&D |
| 2008 Pima B | $130.00 | 5.750% | 6/08 | 9/29 | 1/15 | Unsecured | N/A | SGS Express Line / Local T&D |
| 2009 Pima A (San Juan Project) | $80.41 | 4.950% | 10/09 | 10/20 | Non-Callable | Unsecured | N/A | San Juan Pollution Control |
| 2009 Coconino A | $14.70 | 5.125% | 10/09 | 10/32 | 10/19 | Unsecured | N/A | Navajo Pollution Control |
| 2010 Pima A | $100.00 | 5.250% | 10/10 | 10/40 | 10/20 | Unsecured | N/A | Local T&D |
| 2012 Apache A | $177.00 | 4.500% | 3/12 | 3/30 | 3/22 | Unsecured | N/A | SGS 1 & 2 Pollution Control |
| **Subtotal** | **$609.32** | | | | | | | |
| TAX-EXEMPT BONDS (VARIABLE RATE) | | | | | | | | |
| 1982 Pima Irvington | $38.70 | 0.180% | 10/82 | 10/22 | Anytime | Mortgage Bonds | 11/16 | Local T&D and Sundt 4 |
| 1982 Pima TEP Projects | $39.90 | 0.160% | 12/82 | 12/22 | Anytime | Mortgage Bonds | 11/16 | Local T&D and Four Corners P.C. |
| 1983 Apache A (1) | $100.00 | 1.280% | 12/83 | 12/18 | Anytime | Mortgage Bonds | 11/16 | SGS Unit 2 (Local Furnishing) |
| 2010 Coconino A | $36.70 | 0.250% | 12/10 | 10/32 | Anytime | Mortgage Bonds | 12/14 | Navajo Pollution Control |
| **Subtotal** | **$215.30** | | | | | | | |
| **TOTAL LONG-TERM DEBT** | **$1,074.62** | | | | | | | |

(1) Interest rate reflects 0.16% floating rate at 3/31/12 and 2.40% fixed-for-floating interest rate swap on $50 mil. notional amount.

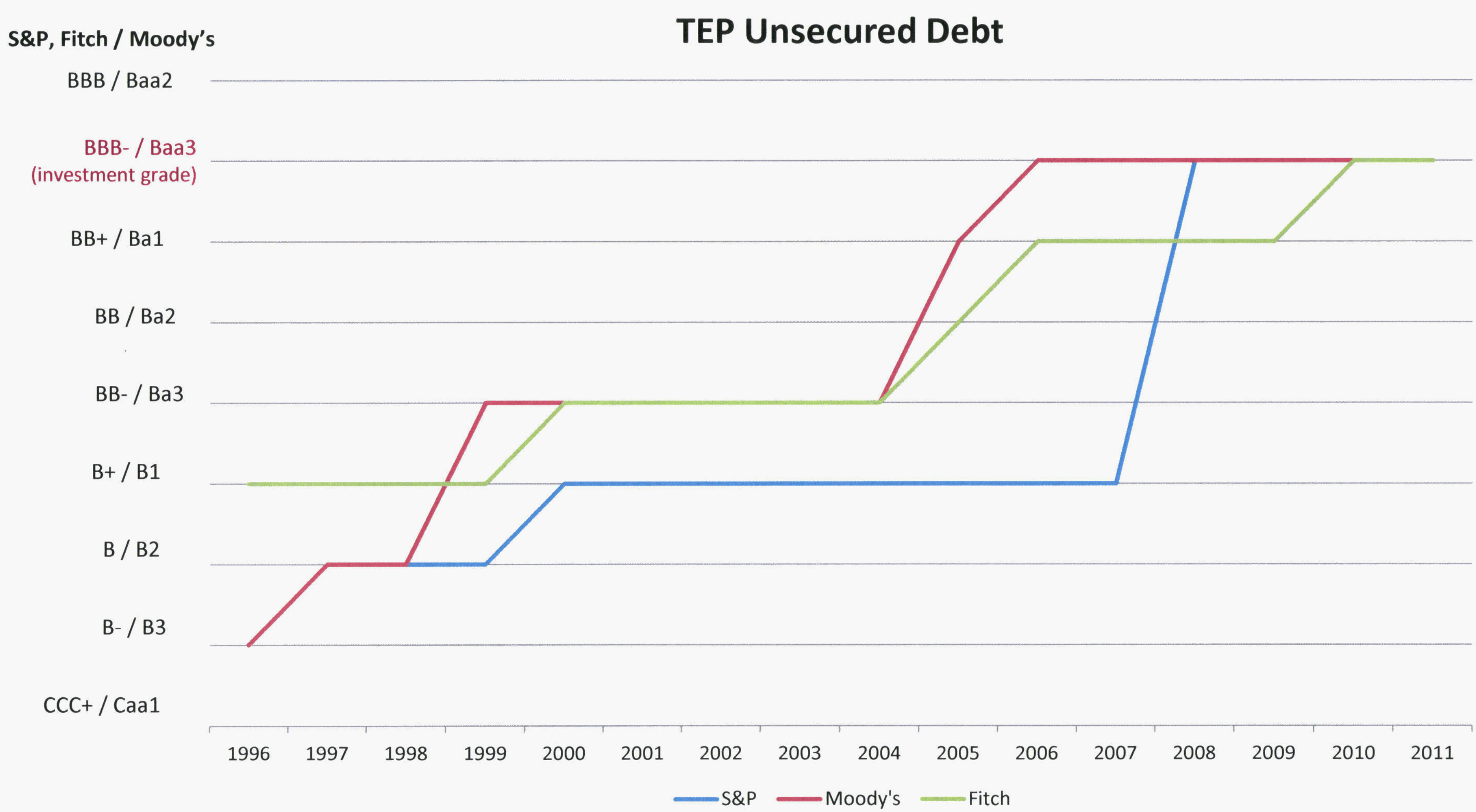
# EXHIBIT

# "B"

# Credit Ratings Trends



# Credit Ratings Trends



# EXHIBIT

# "C"

**PUBLIC NOTICE OF AN APPLICATION BY TUCSON ELECTRIC POWER COMPANY FOR A FINANCING ORDER AUTHORIZING VARIOUS FINANCING TRANSACTIONS**

**DOCKET NO. E-01933A-12-____**

On May ____, 2012, Tucson Electric Power Company ("TEP" or the "Company") filed an Application with the Arizona Corporation Commission ("Commission"), Docket No. E-01933A-12-____ for an order authorizing the Company to enter into various financing transactions to issue new long-term indebtedness, refinance existing long-term indebtedness and credit facilities, and to receive equity contributions from its parent company. The requested order would allow TEP to: (1) increase the cap on its long-term indebtedness from $1.3 billion to $1.7 billion; (2) increase the amount of revolving credit facilities from $200 million to $300 million; (3) increase the amount of authorized equity contributions from UNS Energy Corporation ("UNS Energy"), the parent company of TEP from $250 million to $400 million; (4) to secure short-term debt issued pursuant to A.R.S. §40-302.D; (5) extend the period for TEP to enter into these financings by two years to December 31, 2016; and (6) utilize an interest rate hedging program for planned issuances of long-term debt.

Copies of the Application are available on the Internet via the Company's website (www.tep.com), at the Joel D. Valdez Main Library at 101 N. Stone, Tucson, Arizona, 85701, at the Commission's offices at 1200 West Washington, Phoenix, Arizona, 85007 for public inspection during regular business hours, and on the Internet via the Commission's website (www.azcc.gov) using the e-Docket function.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, at a minimum shall contain the following information:

(1) The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor;
(2) A short statement of the proposed intervenor's interest in the proceeding:
(3) Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing;
(4) A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant. Intervention shall be in accordance with A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.

If you have questions about this Application, you may contact the Company at (520) 884-3742. If you wish to file written comments on the Application or want further information on intervention, you may contact the Consumer Services Section of the Commission at 1200 West Washington, Phoenix, Arizona 85007 or call 1-800-222-7000.

The Commission does not discriminate on the basis of disability in admission to its public meetings. Persons with a disability may request a reasonable accommodation such as a sign language interpreter, as well as request this document in an alternative format, by contacting the ADA Coordinator, Shaylin Bernal, at SBernal@azcc.gov, phone number (602) 542-3931. Requests should be made as early as possible to allow time to arrange the accommodation.