

ORIGINAL



0000140324

MEMORANDUM

TO: Docket Control

FROM: Steve M. Olea
Director
Utilities Division

EA for SMO

DATE: November 2, 2012

RE: STAFF REPORT FOR TUCSON ELECTRIC POWER COMPANY
APPLICATION FOR A FINANCING ORDER AUTHORIZING VARIOUS
FINANCING TRANSACTIONS (DOCKET NO. E-01933A-12-0176)

Attached is the Staff Report for Tucson Electric Power Company's application requesting authorization for various financing transactions.

Staff recommends that TEP be authorized to increase its long-term debt threshold by \$400 million, from \$1.3 billion not to exceed \$1.7 billion (with no more than \$250 million as variable debt) through 2016, subject to specified conditions. Staff further recommends authorization to enter into credit reimbursement agreements and authorization to use certain financial derivative securities to manage interest rate risk and exposure.

Any party who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before November 9, 2012.

SMO:JAC:kdh

Originator: John A. Cassidy

Attachment: Original and fourteen copies

RECEIVED
2012 NOV - 2 P 4. 47
AZ CORP COMMISSION
DOCKET CONTROL

Arizona Corporation Commission

DOCKETED

NOV 02 2012

DOCKETED
JSM

Service List for: Tucson Electric Power Company
Docket No. E-01933A-12-0176

Mr. Michael Patten
Roshka DeWulf & Patten, PLC
One Arizona Center
400 E. Van Buren St. – 800
Phoenix, Arizona 85004

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

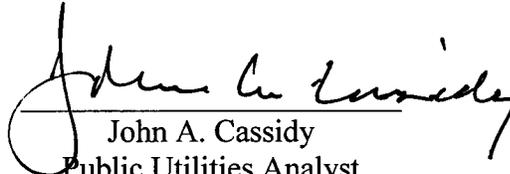
**TUCSON ELECTRIC POWER COMPANY
DOCKET NO. E-01933A-12-0176**

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

NOVEMBER 2, 2012

STAFF ACKNOWLEDGMENT

The Staff Report for Tucson Electric Power Company, Docket No. E-01933A-12-0176 is the responsibility of the Staff members listed below. John A. Cassidy is responsible for the financial review and analysis. Margret Little is responsible for the engineering review and analysis.


John A. Cassidy
Public Utilities Analyst


Margret Little
Utilities Engineer - Electrical

**EXECUTIVE SUMMARY
TUCSON ELECTRIC POWER COMPANY
DOCKET NO. E-01933A-12-0176**

On May 15, 2012, Tucson Electric Power Company ("TEP" or "Company"), a wholly owned subsidiary of UniSource Energy Corporation ("UNS"), filed an application with the Arizona Corporation Commission ("Commission") requesting authorization for various financing transactions.

Staff recommends the following:

1. Authorize TEP through December 31, 2016, 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 (dedicating \$250 million for TEP to exercise its option to acquire the SGS Unit 1 and the SGS coal handling facilities and \$1.45 billion for other purposes), except as provided for in (6) below and limiting to \$250 million the aggregate portion thereof authorized as floating/variable cost rate debt. The general authorization threshold does not include existing capital lease obligations or indebtedness arising under TEP's credit and reimbursement agreements;
2. Authorize 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 (1) above and such financings are in compliance with other provisions of the order;
3. Authorize TEP through December 31, 2016, 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, 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;
4. Authorize TEP to provide security for any financing transactions authorized in this proceeding and for short-term debt issued pursuant to A.R.S. §40-302(D) by the issuance of mortgage bonds under its Mortgage and Deed of Trust;

5. Authorize TEP to receive subsequent to the effective date of the decision in this case additional equity contributions of up to \$400 million from UNS to maintain and augment its equity ratio;
6. Authorize TEP to exceed the long-term debt threshold level set forth in (1) above for a period not to exceed 90 days in circumstances where that threshold is exceeded due to the effect of recognizing both the issuance of refinancing debt and the existing debt to be refinanced;
7. Condition the issuance of long-term indebtedness under the authority set forth in (1) above (other than in the case of refinancing long-term indebtedness)
 - a. Upon TEP having equity equal to at least the following percentages of its total capital by year: 2013, 36 percent; 2014, 37 percent; 2015, 38 percent; and 2016, 39 percent and a cash coverage ratio of at least 1.75.
 - b. For purposes of the Order, the equity ratio and the CCR 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.
 - c. For purposes of the Order, the equity ratio shall be the ratio of (a) common shareholders 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.
 - d. For purposes of the Order, total capitalization shall be defined as the sum of common shareholders equity, preferred stock, long-term debt (including current maturities thereof), capital lease obligations (including current obligations under capital leases), less TEP's investments in capital lease debt.
 - e. For purposes of the Order, the CCR 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 or having been refinanced or refunded with the proceeds of long-term debt being or having been issued subsequent to such period plus interest expense for twelve months on the indebtedness being or having been issued subsequent to such period (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) and where interest expense is adjusted to reflect the effects of any derivative financial securities or similar instruments.
 - f. 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 only if TEP makes 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.

- g. For purposes of the Order, 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 paragraph;
8. Condition the issuance of long-term indebtedness under the authority set forth in (1) above on TEP not having entered into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission, and establishing that violation of this condition shall result in immediate expiration of this general authorization to issue long-term indebtedness (This provision is not intended to place any restriction on hedging activities pertaining to energy procurement);
9. Deny the interest hedging program as proposed by TEP;
10. Direct TEP not to enter into any derivative financial instrument that effectively converts fixed cost long-term debt in (1) above to floating/variable cost debt;
11. Direct that for purposes of calculating the \$250 million aggregate limit on the outstanding balance of floating/variable cost rate long-term debt in (1) above, in the event that the Commission authorizes issuance of derivative financial instruments that effectively convert fixed cost rate debt to floating cost rate debt, the converted debt shall be considered floating cost rate debt;
12. Authorize TEP to enter into derivative financial instruments that convert floating cost long-term securities to long-term fixed cost securities. For purposes of calculating the \$250 million aggregate limit on the outstanding balance of floating/variable cost rate debt in (1) above, any floating cost security effectively converted to a fixed cost security by issuance of a financial derivative instrument or any other means shall be deemed a fixed cost security;
13. Find that it is in the public interest for the Commission to control the use by TEP of interest rate swap agreements, U.S. Treasury rate-lock agreements, derivative financial securities and similar instruments;
14. Require TEP to file confirmation with the Commission Docket Control Center certifying that it has established an appropriate management policy/system of internal controls formally approved by TEP's Board of Directors designed to govern such trading within the organization prior to initiation of trading activity in financial derivative securities or similar contracts to manage interest rate risk and/or exposure;
15. Find that any authorization granted TEP to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculative purposes;
16. Authorize TEP to issue forward-starting swaps based on LIBOR or U.S. Treasuries and U.S. Treasury rate-locks for the purpose of hedging changes in interest rates up to

18 months in advance of planned issuances of fixed-rate taxable long-term debt having final maturity of five years or longer;

17. Deny TEP's request that cash settlement of any hedging contracts be treated as a cost of issuance (either positive or negative) when calculating its cost of debt in future rate proceedings and to instead defer determination of the treatment to a rate case;
18. Authorize 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;
19. Order that the authorization to issue long-term debt, enter into one or more credit agreements for revolving credit facilities and receive additional equity contributions shall replace the existing authorizations of Decision No. 71788, that those authorizations expire upon the effective date of the Order, and that all existing obligations incurred under lawful authorizations shall remain valid;
20. Ordering that the Decision in this case be deemed effective upon issuance and that TEP may enter into the transactions authorized under the Order through December 31, 2016, and that all existing letter of credit facilities and all existing revolving credit facilities that expire before January 1, 2021, incurred under lawful authorization shall remain valid through their maturity dates; and
21. Order that within 90 days of the completion of any financing transaction under the authority set forth in (1), TEP make a compliance filing with the Commission's Docket Control Center in which TEP provides copies of a summary of the transaction and provides 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 and provides to the Utility Division Compliance Section a copy of the relevant agreements.

TABLE OF CONTENTS

	<u>PAGE</u>
INTRODUCTION	1
NOTICE	1
COMPLIANCE	1
BACKGROUND	1
DESCRIPTION OF PROPOSED FINANCING	2
PURPOSE	4
ENGINEERING ANALYSIS	4
FINANCIAL ANALYSIS	5
CAPITAL STRUCTURE	5
CASH COVERAGE RATIO	7
CREDIT AGREEMENT	7
ENCUMBRANCE	8
EQUITY CONTRIBUTIONS.....	8
INTEREST RATE HEDGING	10
CONCLUSIONS AND RECOMMENDATIONS	14

ATTACHMENTS

Engineering Report	A
Public Notice.....	B

Introduction

On May 15, 2012, Tucson Electric Power Company (“TEP” or “Company”) filed an application with the Arizona Corporation Commission (“Commission”) requesting authorization of various financing transactions.

Notice

On June 13, 2012, TEP filed an Affidavit of publication verifying public notice of its financing application. TEP published notice of its financing application in *The Arizona Daily Star* on June 11, 2012. The affidavit of publication is attached along with a copy of the Notice.

Compliance

As of October 18, 2012, a check of the Compliance Section database indicates that TEP is current with its compliance filings.

Background

TEP is a wholly owned subsidiary of the UniSource Energy Corporation (“UNS”), and a for-profit Class “A” Arizona public service corporation located in Tucson, Arizona. TEP is UNS’ largest operating subsidiary. TEP’s electric utility operations contributed 77 percent of UNS’ operating revenues and comprised 82 percent of its assets.¹ TEP is a vertically integrated utility provider, and generates, transmits and distributes electricity to over 404,000 retail customers in a 1,155 square mile service territory in the greater Tucson metropolitan area in Pima County, as well as parts of Cochise County.

The Federal Energy Regulatory Commission (“FERC”) and the Commission regulate portions of TEP’s utility accounting practices and electricity rates. The Commission has authority over TEP’s rates charged to retail customers, the issuance of securities, and transactions with affiliated parties.²

TEP’s current retail rates were established under a settlement agreement authorized in Decision No. 70628, dated December 1, 2008. Pursuant to Decision No. 70628 TEP is subject to a base rate increase moratorium through December 31, 2012.³ On July 2, 2012, TEP filed an application requesting, among other things, a \$127,760,000 (15.3 percent) increase in its non-fuel base rates.⁴

¹ TEP annual report (Form 10-K) for the 12-months ending December 31, 2011, page K-2.

² *Ibid.*

³ Settlement Agreement, page 13.

⁴ Docket No. E-01933A-12-0291.

Description of Proposed Financing

The Company asks that the Commission issue an order:

1. Finding and concluding that the approval of its financing 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 UNS;
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 equity⁵ equal to at least 30 percent of its total capital and a cash coverage ratio ("CCR")⁶ of at least 1.75 when equity is between 30 and 40 percent of total capital,⁷ or a CCR of 1.0 if equity is 40 percent or higher of total capital. The equity ratio and the CCR 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, TEP requests that future changes in generally accepted accounting principles ("GAAP") that have the effect of lowering TEP's equity 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;

⁵ For purposes of the order, TEP requests that the equity ratio 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.

⁶ For purposes of the order, TEP requests that the cash coverage ratio 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).

⁷ For the purposes of the order, TEP requests that total capitalization be 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.

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 the 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.

Purpose

As noted in the Application, TEP intends to use the proceeds from the issuance of new long-term indebtedness to (1) refinance existing long-term indebtedness, (2) finance a portion of the Company's capital expenditure program, (3) finance the purchase of the Springerville Generating Station ("SGS") Unit 1 and SGS coal handling facilities, and (4) pay-off outstanding borrowings under TEP's revolving credit facilities.

TEP intends to use its revolving credit facility (1) as a source of liquidity for working capital purposes, (2) to issue letters of credit to provide credit enhancement to counterparties for the Company's energy procurement and hedging activities; and (3) for other lawful corporate purposes. TEP's stated rationale for requesting additional equity contributions from its parent, UNS, is to maintain a balanced capital structure.

Engineering Analysis

TEP's construction work plan for 2012 through 2016 includes \$1.2 billion for generation, \$191 million for general plant and \$651 million for transmission and distribution projects. Staff concludes that the Company's proposed capital expenditures are appropriate to meet the

projected needs of TEP's existing and new customers and to ensure system reliability. In summary, TEP's capital improvement plan is appropriate and the expenditure levels associated with the projects proposed by the Company appear to be reasonable.⁸ However, Staff makes no determination regarding any ratemaking treatment pertaining to these projects nor should any ratemaking treatment be inferred (see Attachment A for more detail).

Financial Analysis

TEP requests permission to increase its long-term debt threshold from \$1.3 billion to \$1.7 billion. TEP provided support for its \$1.7 billion debt issuance authorization in response to Staff data requests 3.1 and TL 1.1 and TL 2.1. TEP's request asks for general authorization to take on new debt in unspecified amounts over time. The general nature of this request calls for financial parameters to place conditions on the borrowings to prevent TEP 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 broad financial perspective. Equity-to-total capitalization is an effective parameter for providing a balance sheet perspective of financial leverage and risk. The cash coverage ratio ("CCR") provides a measure of a borrower's ability to pay interest expenses with operating cash flow. CCR combined with equity-to-total capitalization can be effective for monitoring appropriate indebtedness. Accordingly, Staff concludes that equity-to-total capitalization and CCR parameters are effective for placing conditions on debt issuances within a framework of threshold authorizations.

Capital Structure

At December 31, 2011, TEP's capital structure consisted of 0.4 percent short-term debt, 3.3 percent current obligations under capital leases, 15.0 percent capital lease obligations, 46.1 percent long-term debt, and 35.2 percent equity (Table 1, below). Staff usually considers equity at 40 percent of total capital as the minimum financially prudent capital structure for an investor owned utility with access to the capital markets. Although, the Company has made continual progress to increase its equity position and reduce leverage, Staff considers the existing 35 percent equity position as the minimum acceptable to TEP. Further, TEP should continue to increase its equity until it achieves and can maintain a capital structure with no less than 40 percent equity.

⁸ In response to Staff data requests TL 1.1 and TL 2.1, the Company provided detail to support its proposed capital expenditures, and in response to Staff data request 3.1, the Company provided a cash flow analysis of its debt issuance requirements for the years 2012 through 2016.

TEP's Capital Structure as of December 31, 2011⁹ (in '000's)		
Short-term Debt	\$10,000	0.4%
Current Obligations Under Capital Leases	\$77,482	3.3%
Capital Lease Obligations	\$352,720	15.0%
Long-term Debt	\$1,080,373	46.1%
Common Equity	\$824,943	35.2%
Total Capital	\$2,345,518	100.0%

Staff concludes that any general authorization for TEP to incur long-term debt within a threshold as proposed by TEP should be subject to the condition that, subsequent to any debt issuance subject to the long-term debt threshold, common equity represents no less than the following percentages of total capital¹⁰ by year: 2013, 36 percent; 2014, 37 percent; 2015, 38 percent; and 2016, 39 percent.,

Approval of the requested new debt limits would negate the necessity of TEP to file financial applications whenever it has the need to enter into any new debt agreements. Approval of the requested debt threshold would provide TEP with the flexibility to take advantage of any favorable conditions in the financial markets when capital needs arise. Accordingly, authorization to increase the long-term debt is appropriate, but should include an expiration date at a date certain to maintain reasonable oversight of TEP's capital financing by compelling it to seek reauthorization.

⁹ TEP annual report (Form 10-K) for the 12-months ending December 31, 2011 (Interactive Data, Balance Sheet of TEP as a stand-alone entity).

¹⁰ Total capital is defined as the sum of common shareholders equity, preferred stock, long-term debt (including current maturities and excluding bonds held in treasury), capital lease obligations (including current obligations), less TEP's investment in capital lease debt.

Cash Coverage Ratio

Cash Coverage Ratio (“CCR”) represents the number of times internally generated cash covers required interest payments on short-term and long-term debt. A CCR greater than 1.0 means that operating cash flow is greater than interest expense.

Staff concludes that any general authorization for TEP to incur long-term debt within a threshold as proposed by TEP should be subject to the condition that, subsequent to any debt issuance subject to the long-term debt threshold, TEP has a CCR equal to or greater than 1.75.

Credit Agreement

In Decision No. 71788, dated July 12, 2010, the Commission granted TEP authorization to refinance or amend its Credit Agreement, and increased the borrowing capacity in its revolving credit facilities to a level of \$200 million. The existing Credit Agreement consists of two credit facilities: 1) a \$200 million revolving credit facility (“Revolver”) and 2) a \$186 million letter of credit facility (“LOC”). TEP now requests to increase the amount of revolving credit facilities under its Revolver by \$100 million, to a level of \$300 million.

TEP utilizes the revolving credit facility under the Credit Agreement 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.¹¹ The revolving credit facility is also used to issue letters of credit, providing credit enhancement to counterparties for TEP’s energy procurement and hedging activities. As stated in the application, the \$100 million increase to the revolving credit facilities will provide TEP with greater liquidity as the Company continues to grow, including the liquidity to support its commodity procurement and hedging activities. Due to recent volatility in the banking and credit markets, TEP requests that any new or amended credit facilities be allowed to have a term of up to five years.

As of March 31, 2012, TEP had \$105 million in outstanding loans under its Revolver. Borrowings against the Revolver bear interest at a spread over London Interbank Offer Rate (“LIBOR”)¹² or an Alternate Base Rate (similar to the prime rate) based on the rating of the credit facilities. As of March 31, 2012, the applicable Revolver borrowing rate was LIBOR plus 1.125 percent per annum resulting in an average interest rate of 1.37 percent. A commitment fee of 0.125 applies to the unused portion of the Revolver.

The LOC does not provide cash proceeds to TEP. The LOC provides credit support for \$179 million aggregate principal amount of tax-exempt bonds and up to \$7 million to cover accrued interest on those bonds. TEP also has a \$7.2 million letter of credit facility to provide

¹¹ In response to Staff data request 3.2, the Company noted semi-annual capital lease payments, posting collateral for energy procurement and hedging, unexpected and/or prolonged generation outage and potential loss of access to the long-term capital markets as other reasons to support its credit agreement request.

¹² LIBOR is the interest rate offered by London banks on deposits made by other banks in the Eurodollar markets.

credit support for the \$36.7 million in variable interest rate tax-exempt bonds issued on its behalf by the Coconino County Pollution Control Corporation and up to \$0.5 million in accrued interest. TEP pays fees related to the LOC based on the ratings of the credit facilities. As of March 31, 2012, the applicable LOC fees were 1.125 percent per annum for the \$186 million LOC and 1.50 percent per annum for the \$37.2 million LOC. TEP's application notes that it also pays an "LOC Fronting Fee" to the banks that are issuers of the LOCs. TEP does not propose to limit the amount of LOC facilities issued to support tax-exempt bonds. Staff concludes that TEP's request not to limit the amount of LOCs is appropriate since the LOCs are self-limiting to the amount of tax-exempt debt authorized and the related accrued interest.

Encumbrance

TEP requests authorization to provide security by the issuance of mortgage bonds under its mortgage and deed of trust for the financing transactions requested herein.

A.R.S. § 40-285 requires public service corporations to obtain Commission authorization to encumber certain utility assets. The statute serves to protect captive customers from a utility's act to dispose of any of its assets that are necessary for the provision of service, thus, it serves to preempt any service impairment due to disposal of assets essential for providing service.

Pledging assets as security typically provides benefits to the borrower in the way of increased access to capital funds or preferable interest rates.

Equity Contributions

A.A.C. R14-2-803.A states that, "Any utility or affiliate intending to organize a public utility holding company or reorganize an existing public utility holding company will notify the Commission's Utility Division in writing at least 120 days prior thereto." Decision No. 58063, dated November 3, 1992, states that a public utility holding company increasing or decreasing its financial interest in an affiliate would be considered a reorganization and therefore would be subject to A.A.C. R14-2-803.

Decision No. 58063 also exempts a public utility holding company from the requirement of A.A.C. R14-2-803 when the holding company increases or decreases its financial interest in an affiliate or utility by an amount not exceeding designated "exempt amounts" based on pre-existing utility assets in all jurisdictions including Arizona. Staff concludes that the current application would be exempt if the reorganization (i.e., equity investment from UNS to TEP) did not exceed \$50 million in one calendar year. However, TEP's application requests authority to receive up to \$400 million in equity from its parent company, UNS.

A.A.C. R14-2-803.A directs the Company to include certain information related to the reorganization in its notice of intent. The Company's application neither directly states that it represents a "notice of intent" to reorganize nor does it directly present the designated information that should be provided related to such a request. TEP's application states that the

purpose of receiving additional equity is to maintain a balanced capital structure. The request to receive up to \$400 million in equity from its parent represents an increase from the \$250 million existing authorization granted by Decision No. 71788. Thus, the request represents an extension in time and amount of an existing authorization. Staff concludes that the information provided by TEP in this circumstance satisfactorily serves as adequate notice.

A.A.C. R14-2-803.B states, "The Commission staff will, within 30 days after receipt of the notice of intent, notify the Applicant of any questions which it has concerning the notice or supporting information. The Commission will, within 60 days from the receipt of the notice of intent, determine whether to hold a hearing on the matter or approve the organization or reorganization without a hearing." TEP's application requests that the Commission issue an Order approving the application by December 31, 2012, and that the application be approved without a hearing.

A.A.C. R14-2-803.C states, "[T]he Commission may reject the proposal if it determines that it would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service."

The application requests authority to receive additional equity capital contributions from UNS for the purpose of maintaining a balanced capital structure. As discussed above, at December 31, 2011, TEP's capital structure consisted of 0.4 percent short-term debt, 3.3 percent current obligations under capital leases, 15.0 percent capital lease obligations, 46.1 percent long-term debt, and 35.2 percent equity, and Staff usually considers equity at 40 percent of total capital as the minimum financially prudent capital structure for an investor-owned utility with access to the capital markets. Accordingly, TEP should continue increasing the proportion of equity in its capital structure until it represents at least 40 percent of total capital. As TEP issues additional debt, the Company will need to grow equity to maintain its current proportion of equity.

A pro forma capital structure recognizing a \$400 million equity contribution is composed of 0.4 percent short-term debt, 3.3 percent current obligations under capital leases, 14.8 percent capital lease obligations, 45.3 percent long-term debt, and 36.2 percent equity.¹³ Since this pro forma capital structure includes less than 40 percent equity, TEP's request to receive additional equity should only serve to provide needed equity enhancement. Therefore, Staff concludes that there is no reason to deny TEP's request to receive up to \$400 million of equity contributions from its parent for the purpose of enhancing its equity position.

¹³ This pro forma capital structure neither reflects changes for debt authorizations requested nor for changes in equity for on-going operations.

Interest Rate Hedging

Forward-starting Swaps:

TEP requests authorization for an interest rate hedging program for planned issuances of long-term debt. Specifically, TEP requests Commission approval of an interest rate hedging program that contemplates hedging (1) up to 50 percent of the planned principal amount of any issuance of fixed-rate taxable long-term debt having a final maturity of five years or longer, (2) through use of one or more forward-starting interest rate swap agreements, U.S. Treasury rate-lock agreements, or other similar derivative interest rate contracts. TEP considers it to be an opportune time to consider such a program for planned issuances of taxable long-term debt, citing as justification interest rates being near all-time lows for investment-grade corporate borrowers, and the forward market for interest rate swaps indicating a much higher interest rate environment in coming years. The application states that implementation of an interest rate hedging program is intended to produce long-term interest savings for TEP and its customers.

TEP asserts that interest rate hedging for new issuances of long-term debt is a common practice among electric utilities having large financing needs. TEP identifies forward-starting interest rate swap agreements or U.S. Treasury rate-lock agreements entered into with a highly rated financial institution as the most common derivative contracts used to hedge interest rate risk when issuing long-term debt, as both hedge that portion of the cost of debt tied to the benchmark U.S. Treasury rate. According to TEP, when hedging interest rate risk for periods of six months or longer, however, forward-starting LIBOR swaps are typically relied upon due to differences in liquidity between the LIBOR and U.S. Treasury swap markets.

As noted in TEP's application, forward-starting swaps based on LIBOR or U.S. Treasuries and U.S. Treasury rate-locks are essentially the same in terms of mechanics and economic impact when used as a hedge. These derivative interest rate contracts are typically used by entities planning to issue fixed rate debt at a future date that also desire to mitigate the potential for interest rates to rise before the issuance date. For instance, assume that the interest rate on long-term debt equals LIBOR or the 10-year treasury rate plus a spread. Also assume that Utility A plans to issue a \$100 million, 10-year debt in 12-months, and the 12-month LIBOR forward rate on a 10-year swap is 2.00 percent today. In order to avoid the impact of a potential increase in interest rates, Utility A can buy a 12-month forward-starting swap on a 10-year, \$100 million notional amount from Counterparty B to effectively ensure that the net present value of its cash flows on the debt issued will reflect the 2.00 percent rate regardless of any increase or decrease in interest rates over that 12-month period.

For example, if at the end of the 12-month period when Utility A issues the debt, the current LIBOR rate is 2.25 percent, Utility A will issue the debt at 2.25 percent plus the spread. Utility A's purchase of the forward-starting interest rate swap entitles it to a payment from Counterparty B equal to the net present value of the 25 basis point (2.25 percent – 2.00 percent)

increase in the LIBOR interest rate on the \$100 million debt for 10 years.¹⁴ If Utility A amortizes the payment received from Counterparty B over the 10-year term of the debt issuance, the effective annual interest cost is 2.00 percent.

Staff concludes that forward-starting swaps are effective for managing interest rate risk and for assisting management in planning and budgeting for future capital improvement expenditures. Accordingly, authorization of forward-starting swaps is appropriate.

In its application, TEP requests that the cash settlement of any hedging contracts entered into as part of its proposed interest rate hedging program be treated as a cost of issuance, with gains (a positive outcome) or losses (a negative outcome) to be factored into the cost of debt in future rate proceedings. Staff concludes that TEP has presented no good reason to pre-determine the treatment of these costs outside of a rate case.

Interest Rate Swaps and Variable Interest Debt:

In its application, TEP states, "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."¹⁵ The Company also notes that it "entered into a fixed-for-floating interest rate swap agreement in 2009 that had the effect of fixing the rate of \$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."¹⁶

An interest rate swap is an agreement between two parties to exchange different streams of interest payments. Typically, one party agrees to pay the other a stream of fixed interest payments in exchange for a stream of variable interest payments from the other party. (In the interest rate swap entered into by TEP discussed above, TEP agreed to pay another party a stream of fixed interest payments in exchange for receiving a stream of variable interest payments from the other party.) The variable interest payments typically are tied to changes in the LIBOR or a United States Treasury rate. For example, assume Utility A plans to issue \$100 million of bonds payable in 20 years, and it also desires to limit its exposure to changes in interest rates. Utility A finds that the cost to issue the bonds at a fixed rate of interest exceeds the cost to issue variable interest 20-year bonds plus the cost to enter into an interest rate swap with Counterparty B where Utility A agrees to pay Counterparty B a fixed stream of interest payments for 20 years based on a \$100 million notional amount and Counterparty B agrees to pay Utility A a stream of interest payments based on a \$100 million notional amount that varies periodically with changes in LIBOR. In this scenario, by issuing the variable interest bonds and negotiating an interest rate swap with Counterparty B, Utility A can effectively achieve its objective - to pay interest at a fixed rate and reduce its costs compared to issuing fixed interest bonds. Thus, a financial derivative is used to reduce interest rate risk and exposure and to reduce

¹⁴ If the LIBOR interest rate decreases, Utility A is obligated to pay Counterparty B.

¹⁵ Company application at p. 16.

¹⁶ Company application at p. 7.

costs. The interest rate swap established a fixed net payment in interest rates, and it protects Utility A from interest rate increases and causes it to pay more interest if interest rates decrease.

However by executing the interest rate swap, Utility A in the example above created a credit exposure – the possibility that Counterparty B will default on its variable interest payments to Utility A. Utility A could enter into yet another financial derivative, a credit default swap, and pay a periodic protection fee to a third party, to mitigate this credit exposure. Utility A will also incur other financial costs related to issuing derivatives, e.g., payroll and overhead costs for financial, legal and other personnel to manage its derivatives.¹⁷

Management of financial derivatives also has non-financial impacts. For example, it adds to the plethora of issues that the Company must manage and distracts from its ability focus on its core business activities.

Use of derivatives for managing risk differs as it pertains to interest rates than for energy transactions. In the case of energy transactions, derivatives address costs that typically vary widely in short periods and are passed through to ratepayers via an adjustor mechanism that provides a true-up of the costs incurred with the revenues collected from ratepayers. Quite differently, interest costs are only measured and included in rates in rate cases which often occur years apart.

The market for debt instruments is reasonably robust and competitive. Competition among lenders results in fixed and floating/variable debt instruments having similar costs on a risk adjusted basis. While the interest rate on variable interest debt may initially be lower (and thus more attractive) than the interest rate on fixed interest debt, the variable interest debt presents greater exposure to risk in the form of higher interest rates. That is, financial instruments with floating/variable cost rates present financial risk (a probability of loss) and exposure (a possibility of loss). The nature of providing utility service places a strong value on cost stability, and the adverse impacts from variable costs should be managed to recognize a preference for cost stability over the risks presented by issuing floating cost financial instruments.

Under a multi-year general authority to issue in excess of a billion dollars in securities, it is prudent to limit the risk and exposure of variable cost financial instruments to the Company and its ratepayers. Despite the reasonably competitive market for debt instruments, the most appropriate debt instrument available to a utility at any time may be a variable debt instrument. Accordingly, Staff concludes that the aggregate outstanding value of floating cost long-term debt

¹⁷ In response to Staff data request 3.3 TEP stated that it has four interest rate swaps in place, and it provided an eight-step process used to enter into interest rate swap contracts. In response to Staff data requests 3.5 and 3.7 TEP stated that it does not have a formal interest rate policy to manage this risk, however, it believes establishing guidelines and parameters is prudent, and it intends to draft a policy by year-end 2012. TEP also noted that its interest rate management strategies and plans for individual interest rate hedges were adequately disclosed to and supported by the Board of Directors and senior management as well as the Finance Committee of the UNS Board of Directors.

threshold that the Commission authorizes for TEP should not exceed \$250 million. For purposes of calculating the aggregate outstanding balance of floating cost financing, any fixed cost security effectively converted to a floating cost security by issuance of a financial derivative instrument or any other means shall be deemed a floating cost security. Further, Staff concludes that the Commission should not grant TEP authorization to enter into any derivative financial instrument that effectively converts a long-term fixed cost security into a long-term floating cost security, nor should the Company enter into any such agreement without Commission authority. To the contrary, Staff concludes that TEP should be granted authority to enter into derivative financial instruments that convert floating cost long-term securities to long-term fixed cost securities. For purposes of calculating the aggregate outstanding balance of floating cost financing, any floating cost security effectively converted to a fixed cost security by issuance of a financial derivative instrument or any other means shall be deemed a fixed cost security.

Staff further concludes that there should be no predetermination that any gain or loss pertaining to fixed-to-floating or floating-to-fixed interest rate transactions or other financial derivative instruments or similar contracts used to manage interest rate risk and/or exposure will be reflected in the net interest rate of the financing instruments to which those transactions relate, and instead that such determination should be deferred to a rate case.

Staff further concludes that prior to initiation of trading activity in financial derivative securities or similar contracts to manage interest rate risk and/or exposure, TEP be required to file confirmation with the Commission Docket Control Center certifying that it has established an appropriate management policy/system of internal controls formally approved by TEP's Board of Directors designed to govern such trading within the organization. Staff further concludes that any authorization granted TEP to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculative purposes.

While TEP may not believe that interest rate swap agreements or U.S. Treasury rate-lock agreements represent an issuance of securities requiring Commission approval, such financial instruments become an integral component of debt issuances, and it is in the public interest to control the use of these financial instruments. Assume a scenario whereby the Commission would approve a fixed interest rate loan, but would deny approval of a floating rate loan. If TEP can enter into interest rate swap agreements without Commission authorization, the Company could circumvent the Commission's wishes by applying for a fixed rate loan, and then, subsequent to receiving approval of the fixed rate debt entering into an interest rate swap to effectively convert the loan to a floating interest rate loan in spite of the Commission's intention. Accordingly, Staff concludes that any general authorization granted to TEP to issue long-term debt under a threshold should be subject to conditions that effectively control the Company's use of derivative financial instruments.¹⁸

¹⁸ Due to the unrestricted authorizations for various types of refinancings granted in Decision No. 71788, TEP's use of fixed-for-floating interest rate swap in 2009 may have been indirectly authorized.

Conclusions and Recommendations

Staff concludes that incurrence of the long-term debt (including revolving credit facilities) for which TEP requests authorization, is within its corporate powers, is compatible with the public interest, would not impair its ability to provide services and would be consistent with sound financial practices if subsequent to any debt issuance subject to the long-term debt threshold (1) common equity represents no less than the following percentages of total capital¹⁹ by year: 2013, 36 percent; 2014, 37 percent; 2015, 38 percent; and 2016, 39 percent; and (2) CCR is equal to or greater than 1.75.

Staff further concludes that:

1. The projects and the related expenditure levels included in the 2012-2016 construction work plan appear to be reasonable; and
2. It is in the public interest for the Commission to have regulatory oversight of the use by TEP of interest rate swap agreements, U.S. Treasury rate-lock agreements, derivative financial securities and similar instruments.

Staff recommends that the Commission:

1. Authorize TEP through December 31, 2016, 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 (dedicating \$250 million for TEP to exercise its option to acquire the SGS Unit 1 and the SGS coal handling facilities and \$1.45 billion for other purposes), except as provided for in (6) below and limiting to \$250 million the aggregate portion thereof authorized as floating/variable cost rate debt. The general authorization threshold does not include existing capital lease obligations or indebtedness arising under TEP's credit and reimbursement agreements;
2. Authorize 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 (1) above and such financings are in compliance with other provisions of the order;

¹⁹ Total capital is defined as the sum of common shareholders equity, preferred stock, long-term debt (including current maturities and excluding bonds held in treasury), capital lease obligations (including current obligations), less TEP's investment in capital lease debt.

3. Authorize TEP through December 31, 2016, 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, 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;
4. Authorize TEP to provide security for any financing transactions authorized in this proceeding and for short-term debt issued pursuant to A.R.S. §40-302(D) by the issuance of mortgage bonds under its Mortgage and Deed of Trust;
5. Authorize TEP to receive subsequent to the effective date of the decision in this case additional equity contributions of up to \$400 million from UNS to maintain and augment its equity ratio;
6. Authorize TEP to exceed the long-term debt threshold level set forth in (1) above for a period not to exceed 90 days in circumstances where that threshold is exceeded due to the effect of recognizing both the issuance of refinancing debt and the existing debt to be refinanced;
7. Condition the issuance of long-term indebtedness under the authority set forth in (1) above (other than in the case of refinancing long-term indebtedness)
 - a. Upon TEP having equity equal to at least the following percentages of its total capital by year: 2013, 36 percent; 2014, 37 percent; 2015, 38 percent; and 2016, 39 percent and a cash coverage ratio of at least 1.75.
 - b. For purposes of the Order, the equity ratio and the CCR 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.
 - c. For purposes of the Order, the equity ratio shall be the ratio of (a) common shareholders 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.
 - d. For purposes of the Order, total capitalization shall be defined as the sum of common shareholders equity, preferred stock, long-term debt (including current maturities thereof), capital lease obligations (including current obligations under capital leases), less TEP's investments in capital lease debt.
 - e. For purposes of the Order, the CCR 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 or having been refinanced or refunded with the proceeds of long-term debt being or having been issued subsequent to such period plus interest expense for twelve months on the indebtedness being or having been issued subsequent to such period (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) and where interest expense is adjusted to reflect the effects of any derivative financial securities or similar instruments.
- f. 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 only if TEP makes 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.
 - g. For purposes of the Order, 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 paragraph;
8. Condition the issuance of long-term indebtedness under the authority set forth in (1) above on TEP not having entered into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission, and establishing that violation of this condition shall result in immediate expiration of this general authorization to issue long-term indebtedness (This provision is not intended to place any restriction on hedging activities pertaining to energy procurement);
 9. Deny the interest hedging program as proposed by TEP;
 10. Direct TEP not to enter into any derivative financial instrument that effectively converts fixed cost long-term debt in (1) above to floating/variable cost debt;
 11. Direct that for purposes of calculating the \$250 million aggregate limit on the outstanding balance of floating/variable cost rate long-term debt in (1) above, in the event that the Commission authorizes issuance of derivative financial instruments that effectively convert fixed cost rate debt to floating cost rate debt, the converted debt shall be considered floating cost rate debt;
 12. Authorize TEP to enter into derivative financial instruments that convert floating cost long-term securities to long-term fixed cost securities. For purposes of calculating the \$250 million aggregate limit on the outstanding balance of floating/variable cost rate debt in (1) above, any floating cost security effectively converted to a fixed cost security by issuance of a financial derivative instrument or any other means shall be deemed a fixed cost security;

13. Find that it is in the public interest for the Commission to control the use by TEP of interest rate swap agreements, U.S. Treasury rate-lock agreements, derivative financial securities and similar instruments;
14. Require TEP to file confirmation with the Commission Docket Control Center certifying that it has established an appropriate management policy/system of internal controls formally approved by TEP's Board of Directors designed to govern such trading within the organization prior to initiation of trading activity in financial derivative securities or similar contracts to manage interest rate risk and/or exposure;
15. Find that any authorization granted TEP to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculative purposes;
16. Authorize TEP to issue forward-starting swaps based on LIBOR or U.S. Treasuries and U.S. Treasury rate-locks for the purpose of hedging changes in interest rates up to 18 months in advance of planned issuances of fixed-rate taxable long-term debt having final maturity of five years or longer;
17. Deny TEP's request that cash settlement of any hedging contracts be treated as a cost of issuance (either positive or negative) when calculating its cost of debt in future rate proceedings and to instead defer determination of the treatment to a rate case;
18. Authorize 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;
19. Order that the authorization to issue long-term debt, enter into one or more credit agreements for revolving credit facilities and receive additional equity contributions shall replace the existing authorizations of Decision No. 71788, that those authorizations expire upon the effective date of the Order, and that all existing obligations incurred under lawful authorizations shall remain valid;
20. Ordering that the Decision in this case be deemed effective upon issuance and that TEP may enter into the transactions authorized under the Order through December 31, 2016, and that all existing letter of credit facilities and all existing revolving credit facilities that expire before January 1, 2021, incurred under lawful authorization shall remain valid through their maturity dates; and
21. Order that within 90 days of the completion of any financing transaction under the authority set forth in (1), TEP make a compliance filing with the Commission's Docket Control Center in which TEP provides copies of a summary of the transaction and provides 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 and provides to the Utility Division Compliance Section a copy of the relevant agreements.

MEMORANDUM

TO: John Cassidy
Utilities Division

FROM: Margaret (Toby) Little 
Electric Utilities Engineer
Utilities Division

THUR: Del Smith
Engineering Supervisor
Utilities Division

DATE: September 19, 2012

RE: TUCSON ELECTRIC POWER COMPANY'S FINANCING APPLICATION
(DOCKET NO. E-01933A-12-0176)

Introduction and Purpose

Tucson Electric Power Company ("TEP" or "Company") submitted an application ("Application") on May 15, 2012 to the Arizona Corporation Commission ("Commission") for authorization 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.

The Company is also seeking Commission approval of an interest rate hedging program for planned issuances of long-term debt. TEP's current financing authority was granted in Decision No. 71788 on July 12, 2010. The Commission Utilities Division Staff ("Staff") engineering review and analysis of the Application is presented in this report.

TEP intends to use the proceeds from the issuance of new long-term indebtedness to refinance long-term indebtedness, finance a portion of TEP's capital expenditures, finance the purchase of Springerville Generating Station ("SGS") Unit 1 and SGS coal handling facilities, and pay-off outstanding borrowings under TEP's revolving credit facilities. TEP intends to use its revolving credit facility as a source of liquidity for working capital purposes, to issue letters of credit to provide credit enhancement to counterparties for TEP's energy procurement and hedging activities, and for other lawful corporate purposes. Both increases are directly related to the growth of TEP and the associated requirements to build new and upgrade existing electric

system infrastructure and to meet increasing reliability needs, all in accordance with its proposed 2012-2016 Construction Work Plan¹ (“CWP” or “Plan”).

Utility Overview

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 interest in property in New Mexico in connection with the generation and transmission of electric power.

Customer and Load Growth

In 2011, TEP provided electric power to approximately 404,300 retail customers in its 1,155 square mile service territory which includes the metropolitan Tucson area in Pima County, as well as parts of Cochise County. The number of residential customers was approximately 367,400, which was approximately 91 percent of the retail customer group; whereas the approximately 36,900 commercial, industrial and public authority customers accounted for approximately 9 percent of that group. With approximately 350,950 total customers in 2001, this reflects an average annual increase of 1.52 percent in customer growth in TEP’s service territory over a ten-year period. As a result of weak economic conditions, TEP’s average number of retail customers grew by slightly less than 1 percent in the years between 2007 and 2012, compared with average annual increases of between 2 and 3 percent from 2002 to 2006. TEP expects retail customer growth to remain at slightly less than 1 percent annually over the next several years.

Historically, the Company’s annual peak retail load grew from 1,840 MW in 2001 to 2,334 MW in 2011, an average annual increase of approximately 2.68 percent over the ten year period. TEP expects its peak retail load to grow at approximately 2.48 percent over the next ten year period, however when taking into account anticipated distributed generation and energy efficiency impacts, the net peak retail demand is expected to grow at slightly less than 1 percent, (0.92%). Retail energy sales increased from 8,346,839 MWh in 2001 to 9,332,107 MWh in 2011, an average annual increase of 1.18 percent. Consistent with projected peak load and customer growth, the Company projects retail sales will also grow at slightly less than 1 percent.

Existing and Future Generation Resources

TEP owns or leases approximately 1,395 MW of coal fired generation and 829 MW of gas fired generation. TEP’s thermal generating capacity and ownership share are shown in Table 1 below:

¹ Work Plan was provided by TEP in response to Staff’s Data Requests TL 1.1 and TL 2.1 under a confidentiality agreement.

Table 1- TEP Generating Capacity Table

Generating Capacity	Share of Unit	Capacity (MW)
Four Corners	7%	110
Navajo	7.5%	168
San Juan	50%	340
Springerville	100%	777
Coal Resources		1,395
Sundt	100%	422
Luna	33%	190
DeMoss CT	100%	75
North Loop CT 1-4	100%	94
Sundt CT 1-2	100%	48
Natural Gas Resources		829
Total Resource Capacity		2,224²

TEP is the Operating Agent for all four units at the coal fired Springerville generating station. The Company owns 100 percent of Unit 2 and leases 100 percent of Unit 1. Springerville Unit 3 is 100 percent owned by Tri-State Generation & Transmission Association (“Tri-State”) and Unit 4 is 100 percent owned by Salt River Project (“SRP”).

TEP owns four steam units at the Sundt Generating Station. Units 1, 2 & 3 are gas fired and Unit 4 can be run on either coal or gas. TEP also owns two combustion turbines at Sundt, four combustion turbines at North Loop and a combustion turbine unit at DeMoss. All of these generating units are located in the Tucson Metropolitan area.

The Company has a one third ownership (190 MW) in the 570 MW Luna Energy Facility, a combined cycle generating unit, located in southern New Mexico, with Public Service Company of New Mexico (“PNM”) and Phelps Dodge as co-owners. TEP also owns 50 percent of San Juan Units 1 & 2 (340 MW); 7.5 percent of Navajo Units 1, 2 & 3 (168 MW); and 7 percent of Four Corners Units 4 & 5 (110 MW).

TEP currently owns or purchases the output from approximately 76 MW of renewable resources. These resources include biogas, Photovoltaic (“PV”) solar and Wind generation, and generate over 190 Gigawatt Hours (“GWH”) per year for an average capacity factor of approximately 30 percent. The Company has firm contracts for another 141 MW of generation to be added by the end of 2013 and 12.8 MW to be added by 2015. At this time, TEP does not have a projection of renewable resources beyond 2015 other than to procure sufficient renewable resources to meet the Arizona Renewable Energy Standard Tariff (“REST”) requirement. With

² TEP procures firm resource capacity to meet summer peak requirements. See Page 4.

the number of uncertainties in the renewable market at this time, TEP feels that it cannot determine the most cost-effective renewable technologies beyond 2015, but expects to add approximately 25 to 50 MW of addition renewable capacity between 2016 and 2022 to meet the REST.

TEP actively procures firm resource capacity in the form of short-term purchase power agreements (“PPAs”) to meet TEP’s summer peak capacity requirements. In addition, TEP maintains two separate Reserve Sharing Agreements with other utilities and is also a participant in the Southwest Reserve Sharing Group which provides additional backup capacity during system contingencies.

A portion of the funds requested in the Application are required to pay for a significant increase in anticipated environmental upgrades at its coal-fired generating facilities and planned investments in renewable energy projects. In addition, long-term lease arrangements covering Springerville Generating Station 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 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 SGA Unit 1 owned by third-party investors. The fixed purchase price option for the SGA coal handling facilities, net of amounts expected to be paid by the owners of SGS Units 3 and 4, is \$73 million.

Transmission System

As of December, 2011, TEP owned approximately 405 circuit-miles of 138 kV lines, and was owner and part owner of 1,088 circuit-miles of 345 kV lines and 512 circuit-miles of 500 kV lines. TEP’s transmission upgrades and expansion plans as included in its Application seem to be adequate and appropriate for meeting the future needs of the Company in providing for its projected load during the 2013-2016 Plan period.

The Company has an on-going program of vegetation trimming and inspection for the transmission system. All 345 kV and 500 kV systems are inspected and vegetation trimmed as necessary on a 5 year cycle and all 138 kV circuits are inspected and trimmed on a 3 year cycle.

TEP is actively participating in the regional and sub-regional transmission planning forums such as Western Electricity Coordinating Council (“WECC”); WestConnect, Southwest Area Transmission System (“SWAT”); and Southeast Area Transmission Study (“SATS”). TEP is also participating in the Central Arizona Transmission System (“CATS”) studies.

Distribution System

As of December 31, 2011, TEP owned or participated in ownership of 479 circuit-miles of 46 kV lines, 2,615 circuit-miles of lower voltage primary line, and 4,389 cable-miles of underground electric distribution lines. The distribution system had an average power factor of over 99 percent every year for the past six years, and the capacity factor during the peak hour was 100 percent for each of those years.

Vegetation trimming for the overhead distribution system is performed on a three to five year cycle. Visual inspections for both the overhead and underground distribution systems are done using a Critical Circuit inspection program. The Critical Circuit methodology is a weighted process that measures several different parameters. The information is used to determine maintenance and reinforcement needs. The parameters that are used in the methodology are:

- 1) The circuit's Indices³ performance compared to the average circuit for that year.
- 2) How the SAIDI² and SAIFI² have been trending since 2003.
- 3) The number of customers on the circuit.
- 4) If there are critical customers on the circuit.
- 5) Circuit performance data given to the Company by a third party benchmarking company.

Customer Reliability

Staff reviewed the Company's system performance indices² for the past six years along with customer complaints relative to reliability for the past year. Customer reliability as evidenced by average SAIDI, CAIDI and SAIFI (see footnote 2) was found to be above average and well within industry standards. In addition, only four complaints with respect to power quality and no complaints with respect to reliability were recorded over the past year. The Company's responses were found to be timely and appropriate.

Review of 2012-2016 Capital Expenditures

In assessing the Company's future capital expenditures, Staff utilized the following criteria:

- Does TEP adequately address the needs of the projected customer and load growth in TEP's service territory?
- Do the capital expenditures on generation, transmission and distribution infrastructure upgrades and new additions appear appropriate and reasonable in meeting the Company's future native load requirements in a reliable and cost effective manner?

Staff has reviewed TEP's total capital expenditures for Generation, Transmission and Distribution ("T&D") and General capital expenditures as included in its Application and as provided in its data responses to Staff's data requests.

³ Industry performance indices: CAIDI is the Average Length of Time Customers Involved in Sustained Outages Were Without Power; SAIDI is the Average Duration of Sustained Outages per Customer; and SAIFI is the Average Number of Sustained Outages per Customer.

Expected Generation expenditures were reviewed for the 2012-2016 period relative to maintenance, replacement of equipment and upgrades of existing facilities and found to be reasonable and comparable to previous years. Included in the CWP is an estimated amount for the purchase of Springerville Unit 1 and the SGS coal handling facilities. Budgeted expenditures for renewable generation are listed under a separate line item and were also reviewed. All expenditures relative to existing and new generation appear to be appropriate and reasonable. TEP's General expenditures appear to be appropriate and reasonable, and are consistent with previous Plans.

TEP's projected T&D capital expenditures also appear to be appropriate and reasonable given the level of load growth projected.

The following Table No. 2 provides a Summary of TEP's forecasted Capital Expenditures for the period of 2012-2016.

Table No. 2

Summary of TEP's Capital Expenditures (Dollars in millions, 2012-2016)	
Generation ⁴	1,182
General	191
Transmission & Distribution	651
Total	2,024

Conclusions and Recommendations

Based on the aforementioned review of TEP's generation, transmission and distribution projects, Staff believes that the Company's proposed capital expenditures are appropriate to meet the projected needs of TEP's existing and new customers and ensure system reliability. TEP's ability to serve its native load reliably and cost effectively is contingent upon the Company's upgrading existing electric facilities, replacing certain equipment and adding new T&D infrastructure. The upgrades that TEP has planned should continue to improve its system from a reliability perspective. Staff further concludes that the expenditure levels associated with the projects proposed by the Company are reasonable. However, this does not imply a specific treatment of rate base for rate making purposes in the Company's future rate filings.

⁴ Includes estimated costs of \$232 million in 2013-2016 to purchase Springerville Unit 1 and the SGS coal handling facilities.

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

DOCKET NO. E-01933A-12-0176

On May 15, 2012, Tucson Electric Power Company ("TEP" or the "Company") filed an Application with the Arizona Corporation Commission ("Commission"), Docket No. E-01933A-12-0176 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) 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 or 400 W. Congress Room 218, Tucson, Arizona, 85701 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.R.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 or 400 W. Congress Room 218, Tucson, Arizona 85701 or call 520-628-6550 outside local area 800-535-0148.

ARIZONA DAILY STAR

Tucson, Arizona

STATE OF ARIZONA)
COUNTY OF PIMA)

Debbie Capanear, being first duly sworn deposes and says: that she is the Legal Advertising Representative of **TNI PARTNERS**, a General Partnership organized and existing under the laws of the State of Arizona, and that it prints and publishes the Arizona Daily Star, a daily newspaper printed and published in the City of Tucson, Pima County, State of Arizona, and having a general circulation in said City, County, State and elsewhere, and that the attached and was printed and

Legal Notice

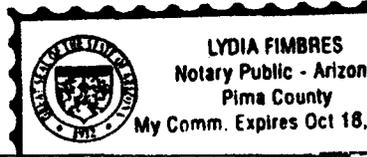
published correctly in the entire issue of the said Arizona Daily Star on each of the following dates, to-wit:

June 11, 2012

Debbie Capanear

Subscribed and sworn to before me this 11 day of
June, 2012

Lydia Fimbres
Notary Public



My commission expires

AD NO. 7795874