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BEFORE THE ARIZONA CORPORATION COMMISSION

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

TUCSON ELECTRIC POWER COMPANY'S COMMENTS TO STAFF REPORT

Tucson Electric Power Company ("TEP" or "Company"), through undersigned counsel, hereby submits its comments to the Staff Report filed in this docket on November 2, 2012.

Overview

TEP has reviewed the Staff recommendations set forth at pages 14-18 of the Staff Report. Set forth below are TEP's comments on each of the recommendations. TEP appreciates Staff's detailed analysis of its application in this docket and agrees with many of the Staff recommendations. However, TEP does have concerns with the specific language of several of the recommendations. Certain of the Staff recommendations as currently stated result in the unintended consequences of precluding or inhibiting TEP's use of the increased financing authority that Staff supports. After reviewing the recommendations, TEP met with Staff on November 13, 2012 to discuss its concerns and potential modification or clarification to certain of the recommendations. As set forth below, for those recommendations that raise concerns, TEP has provided a markup of the Staff recommendation. TEP requests that the Commission adopt the revised conditions in connection with the approval of the financing authority requested in this docket.[1]

Specific Comments

<u>Staff Recommendation 1</u>

TEP Comment:

TEP has two concerns with this recommendation. First, TEP requests that the Commission broaden the language related to the $250 million associated with the acquisition of Springerville Generating Station ("SGS") Unit 1 and the SGS coal handling facilities. TEP would like sufficient flexibility to use the financing authority to acquire other generation or transmission assets in the event that TEP does not exercise its option to purchase the SGS facilities. For example, TEP cannot guarantee that FERC would approve the acquisition.

Second, TEP would prefer not to have a cap on the amount of floating/variable cost rate debt. TEP does not presently have such a cap. Should the Commission desire to now impose a cap, TEP requests that the cap be $350 million, not $250 million as proposed by Staff. TEP would like sufficient flexibility to respond to changes in the capital markets. TEP presently has approximately $165 million of floating/variable cost rate debt that would count toward the cap proposed by Staff. A cap of $250 million provides very little additional opportunity to access this segment of the market. Moreover, TEP has an ability to access tax exempt debt under its two-county financing authority and such debt can offer very favorable floating/variable cost rates.

Proposed Change:

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

[1] It is the Company's understanding that Staff will be filing a reply to these Comments so that the Administrative Law Judge will be in a position to prepare a Proposed Order for the Commission to consider at the December 2012 Open Meeting, but no later than the January 2013 Open Meeting.

(~~dedicating~~ including up to $250 million for TEP to exercise its option to acquire the SGS Unit 1 and the SGS coal handling facilities or other similar generation and/or transmission facilities ~~and $1.45 billion for other purposes~~), except as provided for in (6) below and limiting to $~~250~~ 350 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;

Staff Recommendations 2-5

TEP Comment:

TEP agrees to Recommendations 2 through 5.

Staff Recommendation 6

TEP Comment:

TEP agrees with most of Staff Recommendation 6. However, if a cap on floating/variable cost rate debt is adopted, TEP would suggest expanding the scope of this recommendation to allow the Company to temporarily exceed the cap in the same manner that the long-term debt threshold can be exceeded to allow TEP to take orderly and prudent steps to refinance existing debt, such as allowing TEP to issue refinancing debt up to 90 days in advance of the maturity date of maturing debt rather than being constrained to issue refinancing debt on the maturity date of the existing debt.

Proposed Change:

6. Authorize TEP to exceed the long-term debt threshold level and the limitation on long-term variable rate debt set forth in (1) above for a period not to exceed 90 days in circumstances where that threshold or limit is exceeded due to the effect of recognizing both the issuance of refinancing debt and the existing debt to be refinanced;

Staff Recommendation 7

TEP Comment:

TEP agrees with subparts b through g of Recommendation 7. However, TEP does have concerns with subpart a. The proposed equity ratios may preclude TEP from using the increased financing authority recommended by Staff. While TEP expects to improve its capital structure over time, the minimum equity ratios that Staff recommends provide TEP with very little breathing room on its debt issuance capacity. A more reasonable cushion is needed relative to the Company's current equity ratio in order to ensure that TEP will actually be able to use the debt financing authorized in this order. As an example, the banks which lend to TEP through the existing $200 million revolving credit facility set a maximum debt ratio of 70% for purposed of complying with that agreement, which means that the banks require a minimum equity ratio of only 30%. If the Commission sets a minimum equity ratio that is significantly more stringent than TEP's existing credit facility, this would not only restrict the Company's ability to use the financing authority requested, but may also prompt concerns from the credit rating agencies who routinely monitor TEP's liquidity position and access to capital.

Proposed Change:

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~~ 30 percent; 2014, ~~37~~ 32 percent; 2015, ~~38~~ 34 percent; and 2016, ~~39~~ 36 percent and a cash coverage ratio ("CCR") of at least 1.75.

Staff Recommendation 8

TEP Comment:

This recommendation, as currently written, may create issues for the lending markets and interfere with TEP's ability to acquire new financing under the authority to be granted in this docket. The immediate termination of TEP's financing authority as a result of a violation of this condition could be seen by credit rating agencies and investors as impairing TEP's liquidity position and access to capital. While TEP would certainly act in a manner consistent with Commission orders and regulations, derivatives may be embedded in a variety of commercial contracts that could potentially give rise to questions as to whether a specific hedging transaction had been authorized by the Commission. Moreover, the financial and accounting communities may change their views on what constitutes a derivative. If TEP were unable to issue long-term indebtedness until any such question was resolved, TEP's financial condition and ability to perform its public service obligations could be impaired – especially if it was determined that TEP needed to seek new financing authority from the Commission. Finally, by casting this as a condition to lawful issuance of long-term debt, the validity of debt issued under this authority would be in doubt if there was a subsequent determination that an unknown or undiscovered violation had been in effect when the debt was issued. Therefore, TEP proposes modifying this condition to avoid any unintended consequences which could impair TEP's ability to issue debt by providing sufficient process before a violation is determined and the debt authorization may be terminated by the ACC.

Proposed Change:

8. Direct TEP not to enter ~~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 a decision by the Commission finding a violation of this directive ~~condition shall~~ may 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.);

Staff Recommendation 9

TEP Comment:

TEP agrees to Recommendation 9.

Staff Recommendation 10

TEP Comment:

TEP proposes some clarifying language that provides more specificity about the prohibited transactions.

Proposed Change:

10. Direct TEP not to enter into any floating-for-fixed interest rate swap agreements (i.e., pay floating rate and receive fixed rate) that have the economic effect of converting ~~derivative financial instrument that effectively converts~~ fixed cost long-term debt ~~in (1) above~~ to floating/variable cost debt;

Staff Recommendation 11

TEP Comment:

See Comment to Recommendation 1 regarding the increase to $350 million.

With respect to the remaining modifications, TEP is proposing language that provides more clarity and specificity as to the transactions subject to the recommendation.

Proposed Change:

11. Direct that for purposes of calculating the $ ~~250~~ 350 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~~ the use of floating-for-fixed interest rate swap agreements, the amount of floating/variable cost rate debt shall be deemed to have been increased by the notional amount of any such swap agreements in effect on the date of such determination; ~~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;~~

Staff Recommendation 12

TEP Comment:

See Comment to Recommendation 1 regarding the increase to $350 million.

With respect to the remaining modifications, TEP is proposing language that provides more clarity and specificity as to the transactions subject to the recommendation.

Proposed Change:

12. Authorize TEP to enter into ~~derivative financial instruments~~ fixed-for-floating interest rate swap agreements (i.e., pay fixed rate and receive floating rate) for the purpose of reducing

interest rate risk on its floating/variable cost rate debt. ~~that convert floating cost long-term securities to long-term fixed cost securities.~~ For purposes of calculating the $ ~~250~~ 350 million aggregate limit on the outstanding balance of floating/variable cost rate debt in (1) above, the amount of floating/variable cost rate debt shall be deemed to have been reduced by (i) the notional amount of any fixed-for-floating interest rate swap agreements in effect on the date of such determination and (ii) the principal amount of any floating/variable cost rate debt owned by TEP; ~~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 Recommendation 13

TEP Comment:

Based on TEP's discussions with Staff, TEP is proposing language that it understands better reflects Staff's intent for this recommendation and that tracks the proposed period of time for the financing authorizations.

Proposed Change:

13. Find that it is in the public interest for the Commission to ~~control~~ exercise oversight of the use by TEP of interest rate swap agreements, U.S. Treasury rate-lock agreements, and other interest rate derivatives through December 31, 2016; ~~financial securities and similar instruments;~~

Staff Recommendation 14

TEP Comment:

TEP proposes language that provides a clear deadline for filing compliance documentation and that clarifies what compliance activity TEP must undertake.

Proposed Change:

14. Require TEP to file confirmation with the Commission Docket Control Center within 90 days of the effective date of the Order certifying that it has established an appropriate management policy/system of internal controls formally approved by TEP's Board of Directors designed to govern the use of interest rate derivatives ~~such trading within the organization prior to initiation of~~

~~trading activity in financial derivative securities~~ or other similar contracts to manage interest rate risk and/or exposure;

Staff Recommendations 15-16

TEP Comment:

TEP agrees to Recommendations 15 and 16.

Staff Recommendation 17

TEP Comment:

Based on its discussions with Staff, TEP is proposing language for this recommendation that would allow TEP to account for the hedging of interest rate risk on new long-term debt issuances in a manner consistent with Generally Accepted Accounting Principles ("GAAP"), while preserving the Commission's ability to review the costs of any such hedging in a subsequent rate case.

Proposed Change:

17. With respect to TEP's request in this docket that cash settlement of any hedging contracts be accounted for as a cost of debt issuance (either positive or negative), TEP should account for any such cash settlements in accordance with GAAP, and defer any request for recovery of such costs to a subsequent rate case; ~~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;~~

Staff Recommendations 18-21

TEP Comment:

TEP agrees to Recommendations 18 through 21.

Conclusion

TEP requests that the Commission approve the financing authority requested in this docket with the Staff recommendations as modified above.

RESPECTFULLY SUBMITTED this 14th day of November, 2012.

TUCSON ELECTRIC POWER COMPANY

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