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MEMORANDUM
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TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

AZ CORP COMMISSION
DOCKET CONTROL

DATE: December 4, 2012

RE: **TUCSON ELECTRIC POWER COMPANY'S COMMENTS TO STAFF REPORT**
– TUCSON ELECTRIC POWER COMPANY – APPLICATION FOR A FINANCING
ORDER AUTHORIZING VARIOUS FINANCING TRANSACTIONS – DOCKET NO.
E-01933A-12-0176

On November 2, 2012, Commission Staff filed its Staff Report in the above captioned docket. On November 14, 2012, TEP filed comments to the Staff Report.

Staff has reviewed TEP's comments, and hereby submits its Response.

SMO:JAC:kdh/RRM:BAS

Originator: John A. Cassidy

Attachment: Original and sixteen copies

[Faint handwritten notes and signature]
JSM

Service List for: TUCSON ELECTRIC POWER COMPANY
Docket No. E-01933A-12-0176

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Introduction

On May 15, 2012, Tucson Electric Power Company (“TEP” or “Company”) filed an application with the Arizona Corporation Commission (“Commission”) requesting a financing order authorizing various financing transactions. On November 2, 2012, Staff filed its Staff Report in the matter, requesting that comments be filed on or before November 9, 2012. Staff discussed the Staff Report with TEP via telephonic conference call on November 7, 2012, and after agreeing to provide Staff with a preliminary copy of its suggested changes to the ordering language, the Company was informally granted an extension to file Comments. On November 13, 2012, TEP met with Staff to further discuss its concerns and the potential modification/clarification to certain of Staff’s recommendations. On November 14, 2012, TEP filed Comments to the Staff Report with Docket Control. Staff has reviewed the Comments filed by TEP, and responds as follows.

Staff’s Response to TEP Comments to Staff Report (“Comments”)

In general, TEP appears to support the substantive recommendations made by Staff in this Docket. However, TEP raised concerns with the specific language of several recommendations made by Staff. TEP asserts that, as currently stated, certain Staff recommendations “result in the unintended consequences of precluding or inhibiting TEP’s use of the increased financing authority that Staff supports.” For those Staff recommendations which are of concern to the Company, TEP’s Comments are comprised of a discussion of the concerns it has regarding the ordering language used by Staff, accompanied by TEP’s suggested revisions/modifications to said language. For purposes of the final Order, TEP requests that the Commission adopt the Company’s revised conditions as set forth in its Comments.

Clarification/Modification to Staff Recommendation 1

Staff Recommendation

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.

As indicated in its Comments, TEP has two concerns with the above Staff recommendation. First, TEP requests that the Commission broaden the language relating to its contemplated \$250 million acquisition of Springerville Generating Station (“SGS”) Unit 1 and

the SGS coal handling facilities. TEP states that it presently has an option to purchase the SGS facilities, but in the event the Company either elects not to exercise its purchase option or is unable to obtain regulatory approval for the SGS acquisition from the Federal Energy Regulatory Commission (“FERC”), TEP would like sufficient flexibility to use the financing authority to acquire other generation or transmission assets.

Second, TEP prefers that no cap be placed on the amount of floating/variable cost rate debt the Company may issue and requests that, should the Commission impose such a cap, the cap be increased from \$250 million to \$350 million. TEP points out that it currently has no such cap, and that under its two-county financing authority the Company has access to tax exempt debt at very favorable floating/variable cost rates. As justification for increasing the cap to \$350 million, TEP states that it presently has approximately \$165 million of floating/variable cost rate debt outstanding which would count towards the \$250 million cap recommended by Staff, thus providing the Company “very little additional opportunity to access this segment of the market.”

For the reasons noted in the Staff Report, Staff considers it appropriate to place a limitation on the amount of floating/variable rate cost debt TEP may issue. However, Staff is not opposed to the Company’s request to increase the limit to \$350 million. Staff also agrees the Company should have flexibility dealing with the purchase of SGS. Accordingly, Staff recommends that the ordering language of Staff Recommendation 1 be changed to read as follows:

- 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 (\$250 million of which is available only 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 - including for generation and transmission purposes other than SGS), except as provided for in (6) below and limiting to \$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.*

Clarification/Modification to Staff Recommendation 6

Staff Recommendation

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.

To the extent a cap is placed on the amount of floating/variable cost rate debt the Company may issue, TEP suggests expanding the scope of Staff Recommendation 6 to allow the Company to temporarily exceed the cap in the same manner that the long-term debt threshold can be exceeded to allow the Company to take orderly and prudent steps to refinance existing debt. Staff supports TEP's proposed revisions/modifications to Staff Recommendation 6 and recommends adoption of TEP's revised language.

Clarification/Modification to Staff Recommendation 7(a)

Staff Recommendation

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.

Although TEP agrees with subparts (b) through (g) of Staff Recommendation 7, the Company has concerns with subpart (a) above. Specifically, TEP asserts that Staff's recommended equity ratios may preclude the Company from using the increased financing authority recommended by Staff. While TEP states that it "expects to improve its capital structure over time," the Company asserts that the minimum equity ratios recommended by Staff provide "very little breathing room on its debt issuance capacity." Relative to the Company's current equity ratio, TEP suggests that a "more reasonable cushion" is needed to "ensure that TEP will actually be able to use the debt financing authorized in this order." Accordingly, TEP has proposed that reductions be made to the minimum equity ratios recommended by Staff in 7(a). In support of its proposed change, TEP states that banks which extend loans to the Company through the existing \$200 million revolving credit facility require a minimum equity ratio of only 30 percent. TEP asserts that if the Commission were to establish a minimum equity ratio that is "significantly more stringent than TEP's existing credit facility," the result 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."

Staff disagrees with the Company's assertions. First, as noted in the Staff Report, TEP's current capital structure consists of 35.2 percent common equity, a figure well above its proposed 30 percent equity level for the year 2013. Second, in the Company's prior financing docket,¹ TEP was granted authorization to receive equity contributions of up to \$250 million from its parent company, UNS Energy Corporation ("UNS"). TEP has used only \$75 million² of the existing \$250 million in equity contributions it is authorized to receive from UNS; thus, leaving

¹ Docket No. E-01933A-09-0476.

² UNS contributed equity capital to TEP of \$30 million in 2011, \$15 million in 2010, and \$30 million in 2009. Over this same three year period, TEP paid dividends to UNS of \$60 million in both 2010 and 2009; TEP did not pay dividends to UNS in 2011. (Source: TEP 2011 Form 10-K, Note 7, "Stockholders' Equity")

\$175 million ($\$250\text{M} - \$75\text{M} = \175M) of untapped existing equity contribution capacity which remains available for it to utilize by December 31, 2012. Third, in the present docket, Staff has recommended approval of TEP's request to receive up to \$400 million in equity contribution capacity to draw upon.³

Finally, as to TEP's concerns regarding the minimum equity ratios in Staff recommendation 7(a) being more stringent than the 30 percent level required by the Company's existing credit facility, Staff usually considers equity at 40 percent of total capital to be the "minimum financially prudent capital structure for an investor owned utility with access to the capital markets" (see Staff Report, p. 5). Staff considers maintenance of a healthy capital structure fundamental to and essential for its support in granting TEP general authorization to incur debt within a threshold, as opposed to using individual, specific financing authorizations. If TEP is either unable or unwilling to establish and maintain a capital structure with sufficient equity, then Staff would be hesitant to continue to recommend granting TEP a general authorization for debt issuance. Notwithstanding TEP's ability to issue debt under a general authorization, the option for it to file a request for a specific debt issuance is always available. Staff's willingness to recommend a lower equity percentage for TEP gives recognition to the progress made by the Company to increase its equity position from its formerly depressed and highly leveraged levels. Going forward, however, as a utility with access to the capital markets, Staff expects TEP to meet or exceed its usual 40 percent equity standard in the near future, and the minimum equity levels in Staff Recommendation 7(a) are intended to facilitate that progress.⁴

For the reasons noted above, Staff considers the minimum equity ratios for TEP in Staff Recommendation 7(a) to be appropriate. However, in recognition that TEP may not have anticipated and planned for those recommendations, Staff has no objection to the revisions/modifications to the ordering language of Staff Recommendation 7(a) as they relate to the minimum equity ratios for years 2013, 2014 and 2015, as proposed by the Company as long as the Company achieves the equity ratio recommended by Staff for 2016. Accordingly, Staff recommends that the ordering language of Staff Recommendation 7(a) be changed to read as follows:

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, 30 percent; 2014, 32 percent; 2015, 34 percent; and 2016, 39 percent and a cash coverage ratio of at least 1.75. In future financing*

³ In this docket, TEP requests authorization to increase its long-term indebtedness threshold by \$400 million ($\$1.7\text{B} - \$1.3\text{B} = \400M). The \$400 million of equity contribution capacity available to TEP represents 100 percent of its incremental long-term debt capacity. Thus, as recommended by Staff, for every \$1.00 of additional indebtedness to be authorized in this docket, TEP will be provided authorization to receive \$1.00 in equity contributions from its parent, UNS.

⁴ In the Company's current rate case (Docket No. E-01933A-12-0291), TEP has proposed a capital structure consisting of 46.0 percent common equity and 54.0 percent long-term debt. (Source: Direct Testimony of John J. Reed, p. 34)

approvals for TEP, the Commission may require TEP's equity to be 40 percent or greater.

Clarification/Modification to Staff Recommendation 8

Staff Recommendation

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).

As currently written, TEP correctly points out that Staff Recommendation 8 above calls for the immediate termination of the long-term indebtedness authority to be granted in this docket should the Company issue a financial derivative security other than those expressly authorized by the Commission. For the reasons noted by TEP in its Comments, Staff agrees with the Company that casting such a condition to the lawful issuance of long-term debt may lead to unintended consequences; among them, the potential for TEP's financial condition and ability to perform its public service obligations to be impaired. Accordingly, Staff proposes that Staff recommendation 8, above, be modified to read as follows:

8. *Direct TEP not to enter into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission, and establishing that execution by TEP of any such transaction shall be grounds for summary revocation by the Commission of the general authorization to issue long-term indebtedness authorized in this proceeding (This provision is not intended to place any restriction on hedging activities pertaining to energy procurement).*

Clarification/Modification to Staff Recommendation 10

Staff Recommendation

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.

In the Comments, TEP proposes clarifying language to provide more specificity about the prohibited transactions in Staff recommendation 10, above. Staff has no objection to TEP's proposed revisions/modifications to Staff Recommendation 10 and recommends adoption of TEP's revised language.

Clarification/Modification to Staff Recommendation 11

Staff Recommendation

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 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.

TEP's Comments relating to Staff Recommendation 11 above consist of (a) a proposed increase in the amount of floating/variable cost rate debt, from \$250 million to \$350 million, and (b) proposed changes to the language providing more clarity/specificity to the transactions subject to the recommendation. Staff has no objection to TEP's revisions/modifications to Staff Recommendation 11 and recommends adoption of TEP's revised language.

Clarification/Modification to Staff Recommendation 12

Staff Recommendation

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.

TEP's Comments relating to Staff Recommendation 12 above consist of (a) a proposed increase in the amount of floating/variable cost rate debt, from \$250 million to \$350 million, and (b) proposed changes to the language providing more clarity/specificity to the transactions subject to the recommendation. Staff supports TEP's revisions/modifications to Staff Recommendation 12 and recommends adoption of TEP's revised language.

Clarification/Modification to Staff Recommendation 13

Staff Recommendation

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.

Based on its discussions with Staff, TEP has proposed language which better reflects Staff's intent for Staff Recommendation 13 above. Accordingly, Staff supports TEP's

revisions/modifications to Staff Recommendation 13 and recommends adoption of TEP's revised language.

Clarification/Modification to Staff Recommendation 14

Staff Recommendation

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.

In its Comments, TEP proposes language that provides a clear deadline for filing compliance documentation and that clarifies what compliance activity TEP must undertake. Staff has no objection to the revisions/modifications to Staff Recommendation 14, as proposed by TEP.

Clarification/Modification to Staff Recommendation 17

Staff Recommendation

17. Deny TEP's request that cash settlement of any hedging contracts be treated as a cost of debt 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.

Based on its discussions with Staff, TEP proposes language to Staff Recommendation 17 above which 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 transactions in a subsequent rate case. Staff and TEP are generally in agreement as to the Commission's "ability to review" such costs in a future rate proceeding and that TEP is responsible for recording its transactions in accordance with GAAP. Staff has no intention to modify the method TEP uses to record these costs due to Staff's recommendation in this case. However, Staff prefers the following revision to Staff recommendation 17 as opposed to the Company's proposed revision:

8. *Decline to establish the ratemaking treatment for the cash settlement of any hedging contracts, as requested by TEP in this docket, on the basis that such determination is better made in the context of a rate case.*

This concludes Staff's Response to TEP's Comments.