NEW APPLICATION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR AN ACCOUNTING ORDER IN CONNECTION WITH THE ACQUISITION OF UP TO A 25% INTEREST IN GILA RIVER POWER PLANT UNIT 3.

DOCKET NO. E-04204A-13-0476

APPLICATION

UNS Electric, Inc. ("UNSE" or "Company") requests that the Arizona Corporation Commission ("Commission") approve an accounting order authorizing the deferral for future recovery of non-fuel costs associated with the Company's prospective purchase of up to a 25% interest in Unit 3 at the Gila River Power Plant ("Unit 3" or the "Plant"). These costs would include depreciation and amortization costs, property taxes, O&M expenses and carrying costs associated with owning, operating and maintaining the Plant.

This proposed order would allow UNSE to address its need for base load generation through the timely acquisition of a uniquely appropriate resource without compromising the Company's financial stability. UNSE's share of this efficient, combined cycle natural gas-fired unit would be purchased at a reasonable price which is only possible through an opportune partnership with sister company Tucson Electric Power ("TEP"). The Plant would provide near-term benefits to UNSE customers through lower purchased power costs and reduced exposure to potentially volatile market power prices. The proposed accounting order also would help UNSE maintain its investment-grade credit rating during the cost deferral period. For these and other reasons, the public interest would be served by the Commission's approval of the proposed accounting order described in greater detail below.

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I. UNSE'S CURRENT GENERATING PORTFOLIO.

UNSE currently lacks base load generation. The Company serves its 93,000 customers primarily with power purchased from the wholesale energy and capacity market. Its generation assets are limited to simple cycle natural gas-fired combustion turbines used primarily for on-peak power and reserve capacity. These include the Black Mountain Generating Station, a Mohave County facility equipped with twin 45-megawatt ("MW") turbines, and the Valencia Generating Station in Nogales, which includes four 14-MW turbines.

UNSE's heavy reliance on wholesale power has not proven problematic in recent years where affordably priced resources have been widely available. Over the long term, though, the Company's customers could face significantly higher rates and potential reliability concerns if coal plant closures, carbon costs, increased growth rates or other market forces drive up energy and capacity costs and restrict the availability of market resources. The Commission acknowledged this risk in May 2013 when it advised UNSE and other load serving entities about future short-term market purchases in their long-term Integrated Resource Plans ("IRPs"):

> *The cost and availability of such purchases are subject to a wide array of influences that are difficult, if not impossible to predict. For example, if a large number of older coal-fired generating plants are retired in the western region, the availability of such purchases will decline dramatically, and the cost of such purchases will increase significantly. Reliance on short term market purchases in a long-term plan is difficult, if not impossible, to justify.* (Decision No. 73884, Page 4)

For similar reasons, UNSE's 2012 IRP establishes the Company's need for base load resources. While the plan projects that energy efficiency programs will reduce the Company's combined retail load and reserve margin from 511 MW in 2013 to 469 MW by 2023, it nonetheless calls for new base load resources to stabilize UNSE's long-term energy outlook. Citing the high cost of new construction and UNSE's relatively modest base load energy needs, the plan instead identifies an interest in a particular type of acquisition:

> *UNS Electric will monitor the market for economically attractive plant acquisition opportunities. A low cost, multi-owner acquisition of an existing combined cycle gas fired plant would enable UNS Electric to firm up its longer-term capacity needs while realizing economies of scale through a multi-owner plant configuration* (UNSE IRP at Page 13)

II. THE PLANNED ACQUISITION.

The planned acquisition of Unit 3 would satisfy UNSE's base load energy needs under the precise circumstances articulated in the Company's 2012 IRP. Under terms of the Asset Purchase and Sale Agreement ("Agreement"), TEP and UNSE would purchase the 550-MW unit for approximately $219 million. UNSE's share of this purchase price would be approximately $55 million, or Approximately $398 per kW.[1] UNSE and TEP also would secure transmission rights necessary to deliver the plant's output to transmission hubs linked to their respective service territories in Mohave, Santa Cruz and Pima Counties. In this way, the purchase would provide UNSE with a stable, efficient source for 30 to 40 percent of its long term capacity needs, reducing its reliance on the wholesale market and helping the Company reliably integrate an increasing share of renewable resources into its portfolio.

Unit 3 is uniquely well suited for these tasks. The Plant is located approximately 75 miles southwest of Phoenix and about 30 miles south of the Palo Verde trading hub – nearly equidistant from UNSE's Mohave County and Santa Cruz County service areas. The Plant is linked to the Palo Verde hub by a pair of 500-kilovolt (kV) transmission lines with firm, long-term transmission rights to the Jojoba Switchyard. The Plant also can be served by both the El Paso Natural Gas and Transwestern Pipeline Company, L.L.C., which provide competitive access to the Permian, San Juan and Anadarko supply basins.

The 10-year-old, 2,200 MW Gila River Power Plant includes four 550-MW power blocks, making it the largest natural gas-fired generating facility in the Western Electric Coordinating Council ("WECC") market zone. The Plant also is one of the most efficient combined cycle plants in the WECC region, with a heat rate of approximately 7,000 British thermal units ("BTUs") per

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[1] On December 23, 2013, TEP and UNSE entered into the Agreement to purchase Gila River Unit 3 for $219 million. The purchase price is subject to adjustments to prorate certain fees and expenses through the closing and in respect of certain operational matters. It is anticipated that TEP will purchase a 75% undivided interest in Gila River Unit 3 for approximately $164 million and that UNSE will purchase the remaining 25% undivided interest for approximately $55 million, although TEP and UNSE may modify the percentage ownership allocation between them. TEP and UNSE expect the transaction to close no later than December 2014, assuming FERC approval and satisfaction of other transaction contingencies.

kilowatt-hour ("kWh"). At that heat rate, the Plant generates power more efficiently than the average resource available on the wholesale market and easily bests UNSE's simple cycle combustion turbines, which operate at heat rates ranging from 9,800 to 16,000 BTU/kWh.

UNSE's opportunity to purchase a share of the plant arose after TEP issued a request for proposals ("RFP") in May 2013 for generating resources in accordance with the Commission's IRP Rules.[2] Gila River Power L.L.C. ("Gila River Power"), a subsidiary – through several intermediaries – of Entegra Power Group L.L.C., and owner of Units 3 and 4 at the Plant, responded to the RFP with an offer to sell Unit 3. After reviewing that offer and other available options, TEP concluded that ownership of the Plant would serve the best interests of UNSE and its customers. Additionally, based on the large size of the Plant and the base load needs of UNSE, it was determined that joint ownership of the Plant would be in the best interest of both UNSE and TEP and their respective customers. A comparison of the capital costs and life-cycle levelized costs of the proposed acquisition versus other alternatives, attached as **Exhibit 1,** shows the purchase will prove far less expensive than a similar commitment in a newly constructed combined cycle plant, resulting in $136 million of net present value for UNSE customers.

If the proposed purchase is finalized and approved by the Federal Energy Regulatory Commission ("FERC")[3], the Plant would continue to be operated by Gila Bend Operations Company, L.L.C. ("GBOC"), a special purpose entity created through a joint ownership agreement between Gila River Power and Sundevil Power Holdings L.L.C., owner of Units 1 and 2. The GBOC limited liability company agreement will be amended at closing of the Agreement to reflect TEP's and UNSE's joint ownership of Unit 3 and corresponding twenty-five percent (25%) joint ownership interest in GBOC. Other terms and conditions of the proposed acquisition are contained in the Agreement.

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[2] A.A.C. R14-2-701 through R14-2-706.

[3] UNSE, together with TEP and Gila River Power, will seek approval by FERC under Section 203 of the Federal Power Act of 1935 and Part 33 of the FERC Regulations. APS also will transfer 550 MW of long-term firm point-to-point transmission service on the 500-kV transmission lines to Jojoba to UNS Electric and TEP.

For TEP, the purchase represents a well-measured step to diversify a generation portfolio that currently exceeds 2,000 MW of company-owned capacity. The acquisition would help offset the reduction in capacity resulting from TEP's decision to purchase only a portion of its leased interest in Unit 1 at the Springerville Generating Station as well as the potential loss of capacity resulting from the prospective closure of Unit 2 at the San Juan Generating Station.

For UNSE, a much smaller company, the proposed acquisition represents a more substantial financial commitment on a relative basis. The purchase price would represent nearly 28 percent of the original cost rate base approved in the Company's recently completed rate case. Without action by the Commission, UNSE would incur substantial costs without any prospect of future recovery until the Plant is reflected in non-fuel rates in the Company's next general rate case.

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III. THE COMPANY'S REQUEST.

To facilitate this planned purchase, UNSE requests that the Commission approve an accounting order authorizing the Company to defer for future recovery specific non-fuel costs related to its planned ownership stake in the Plant, including: (i) depreciation and amortization costs, (ii) property taxes, (iii) O&M expenses, (iv) a carrying cost on the Plant investment ("carrying costs"), and (v) any other non-fuel Plant costs. UNSE expects these costs will total approximately $9 million by the end of 2015. Upon approval of this request and completion of the sale, the Company would record a regulatory asset in accordance with relevant FERC and accounting standards to defer those costs until the Company's interest in the Plant is put into rate base in UNSE's next rate case.

Depreciation would be calculated based on the expected useful life of the Plant, while the O&M and property taxes deferred would reflect the actual amounts incurred. UNSE requests deferral of carrying costs based on the average cost of debt of 5.97% approved by the Commission at its December 17, 2013 Open Meeting in connection with UNSE's recent rate case (Docket No. E-04204A-12-0504). Although UNSE intends to use a combination of debt and equity capital to finance the purchase of its share of the Plant, the Company is willing to use its average cost of debt for the purpose of calculating carrying costs, which would result in a lower balance of deferred costs subject to future rate recovery.

This proposed accounting order is permitted under FERC Uniform System of Accounts ("USOA") guidelines,[4] which the Commission has adopted as part of its regulation of electric utilities.[5] The Commission has approved similar orders for APS in association with its 2005 acquisition of the Sundance Generating Station in Coolidge and, more recently, its plan to acquire Southern California Edison's share in Four Corners Generating Station ("Four Corners") Units 4 and 5 while retiring Units 1 through 3.[6]

In this case, the accounting order would serve the public interest by supporting UNSE's financial stability and investment-grade credit rating until the Plant's costs could be addressed in a future rate case. The Company's debt obligations are currently rated Baa2 by Moody's Investor Service ("Moody's"). The accounting order would be important from the standpoint of perceived level of regulatory support for UNSE, a key factor considered by Moody's and others in evaluating the Company's creditworthiness. Without such treatment, the planned purchase of the Plant would impose undue and potentially untenable financial burdens on UNSE given the size of the planned investment relative to the Company's current capitalization.

Approval of the proposed accounting order also would strike an appropriate balance between the Company's shareholders and UNSE's customers. Upon closing of the planned purchase, the Company's customers would benefit from the reduction in purchased power expenses that would result from the Plant's acquisition. The resulting savings would be passed

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[4] See e.g. FERC Order 552 (Docket No. RM92-1) (March 31, 1993) (allowing for the creation of regulatory assets and liabilities through actions of regulatory agencies – establishing FERC Accounts 182.3 and 254).

[5] See A.A.C. R14-2-212(G)(2).

[6] See Decision No. 67504 (January 20, 2005) (regarding Sundance Generating Station) and Decision No. 73130 (Four Corners Generating Station). In accordance with *Accounting Standards Codification (ASC) 980 – Regulated Operations*, UNS Electric may defer the capitalized costs as a regulatory asset under Generally Accepted Accounting Principles ("GAAP") only if it is probable that the Company will be allowed to recover them through future rates; otherwise, such costs must be recorded as an expense. Consequently, UNS Electric seeks language similar to what was provided for APS in Decision No. 73130 (April 24, 2012).

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onto UNSE customers almost immediately through operation of the 12-month rolling average provision in UNSE's new Purchased Power and Fuel Adjustment Clause ("PPFAC").[7] Preserving the Company's ability to recover the non-fuel Plant costs during this same period therefore would strike an appropriate balance between shareholders and customers.

The accounting order also would facilitate a transaction that creates significant long-term benefits for UNSE's customers. As noted above, this opportune partnership with TEP provides access to a right-sized share of an efficient, combined-cycle natural gas fired plant that is uniquely situated to serve its long-term base load energy needs. UNSE would be unable to build or purchase a comparable resource without such a partnership, and the unique benefits provided by this Plant are simply unavailable outside of this transaction.

In conclusion, the public interest would be well served by the Commission's approval of an accounting order that would facilitate UNSE's planned acquisition of a 25% stake in Unit 3 at the Gila River Power Plant.

IV. PROPOSED ORDERING LANGUAGE.

UNSE requests approval of the language below, which is modeled after the Commission's order in Decision No. 73130 regarding APS's Four Corners acquisition. The proposed language would make clear that UNSE is authorized to defer certain costs associated with the purchase and operation of Unit 3 for future recovery. The language is intended to provide UNSE with a reasonable assurance of recovery, subject to review for reasonableness and prudence, so the Company can record those costs as a regulatory asset in accordance with GAAP requirements. UNSE also would agree to the reporting requirements contained in Decision No. 73130 and provided below:

> IT IS THEREFORE ORDERED that UNS Electric, Inc. is authorized to defer for possible later recovery through rates, all non-fuel costs (as defined herein) of owning, operating and maintaining up to an acquired 25 percent interest in Gila River Power Plant Unit 3 and associated facilities. Nothing in this Decision shall

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[7] Any purchased power savings not yet passed along to customers by the time UNSE's next rate case is resolved could be used to offset any approved increase in base rates in that matter.

be construed in any way to limit this Commission's authority to review the entirety of the acquisition and to make any disallowances thereof due to imprudence, errors or inappropriate application of the requirements of this Decision.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall reduce the deferrals by any fuel and purchased power savings and off-system sales not otherwise reflected in its Purchased Power and Fuel Adjustment Clause.

IT IS FURTHER ORDERED that the accumulated deferred balance associated with all amounts deferred pursuant to this Decision will be included in the cost of service for rate-making purposes in UNS Electric, Inc.'s next general rate case. Nothing in this Decision shall be construed to limit this Commission's authority to review such balance and to make disallowances thereof due to imprudence, errors or inappropriate allocation of the requirements of this Decision.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall prepare and retain accounting records sufficient to permit detailed review, in a rate proceeding, of all deferred costs and cost benefits as authorized herein.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall prepare a separate detailed report of all costs deferred under this authorization and shall include that report as an integral component of each of its general rate applications in which requests recovery of those deferred costs.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall file an annual status report for each preceding calendar year, of all matters related to the deferrals, and the cumulative costs thereof every April 1 with Docket Control, as a compliance item in this Docket, with the first such report due not later than April 1, 2015.

V. CONCLUSION.

UNSE requests that the Commission: (i) authorize the Company to defer for future recovery non-fuel costs associated with acquiring, operating and maintaining up to a 25% share of Gila River Power Plant Unit 3, and (ii) issue an order by end of the third quarter of 2014 consistent with the proposed language provided in Section IV. UNSE also requests that the Commission provide any other relief necessary to allow such deferral and future recovery.

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RESPECTFULLY SUBMITTED this 31st day of December, 2013.

UNS ELECTRIC, INC.

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Original and 13 copies of the foregoing
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Copies of the foregoing hand-delivered/mailed
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Exhibit 1

Unit Capacity (MW)	137.5
Weighted Average Cost of Capital	7.83%
Levelized Cost of Fuel ($/mmBtu)	$6.54
Average Capacity Factor	41.7%

	Gila River Acquisition	New Build Construction Costs
Cost of Installed Capacity	$54,750	$181,500
Cost of Installed Capacity ($/kW)	$398	$1,320
NPV Revenue Requirements	$323,850,664	$459,643,777
Levelized Cost of Energy ($/MWh)	$79.72	$113.14

NPV Revenue Requirement Savings	$135,793,113

The 15-year revenue requirement and levelized cost of energy are based on a 2015-2029 forecast, excluding any future carbon legislation costs.

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