TEP
Tucson Electric Power
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July 28, 2014

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

Re: Notice of Compliance Filing – Tucson Electric Power Company
Decision No. 73912, Docket No. E-01933A-12-0291

Pursuant to Section *10.1 of the Settlement Agreement* approved by Arizona Corporation Commission ("Commission") Decision No. 73912 (June 27, 2013), Tucson Electric Power Company ("TEP") is required to file a report with the Commision no later than July 31, 2014, addressing the status of the Springerville Generating Station ("SGS") lease agreements and the estimated change in TEP's non-fuel revenue requirement at the conclusion of each primary lease term. TEP hereby files its status report regarding the SGS lease agreements and related purchase commitments.

If you have any questions, please contact me at (520) 884-3680.

Sincerely,

Jessica Bryne

Jessica Bryne
Regulatory Services

cc: Parties to the Docket
Compliance Section, ACC

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SECTION 1 – EXECUTIVE SUMMARY

Introduction

Decision No. 73912 (June 27, 2013) approved a settlement agreement ("Settlement Agreement") that, among other things, established the current rates charged to the retail customers of Tucson Electric Power Company ("TEP" or the "Company").

This report fulfills the following compliance requirement set forth in Section 10.1 of the Settlement Agreement:

> 10.1 TEP shall file a report with the Commission no later than July 31, 2014, addressing the status of the Springerville Generating Station ("SGS") lease agreements and the estimated change in TEP's non-fuel revenue requirement at the conclusion of each primary lease term. Specifically, TEP commits to reporting on the following matters:
>
> - The details concerning any commitments made by TEP to purchase SGS Unit 1, or any agreements entered into by TEP to otherwise retain capacity rights to SGS Unit 1, after the end of the primary lease term in January 2015;
> - The details concerning any commitments made by TEP to purchase replacement generating resources, or any purchased power agreements entered into by TEP for replacement power, if TEP elects not to purchase or otherwise retain capacity rights to SGS Unit 1 after the end of the primary lease term in January 2015;
> - The details concerning any commitments made by TEP to purchase the SGS Coal Handling Facilities, or any agreements entered into by TEP to extend the Coal Handling Facilities lease term, after the end of the primary lease term in April 2015; and
> - The estimated non-fuel revenue requirement associated with each of the commitments described above, including the proposed rate treatment of any remaining balance of SGS leasehold improvements.

Purchase Commitments

As filed in TEP 2014 Integrated Resource Plan[1], the Company plans to make the following investments as a result of the expiration of the leases related to the Springerville Generating Station (collectively the "Purchase Commitments):

[1] Filed on April 1, 2014

- purchase 35.4% of Springerville Generating Station Unit 1 ("SGS Unit 1") and associated common facilities at or near the end of the lease term in January 2015;
- acquire at least 75% of Unit 3 of the Gila River Generating Station ("Gila River Unit 3") in December 2014 to replace forgone capacity from the portion of SGS Unit 1 that TEP will not own; and
- purchase the Springerville Generating Station Coal Handling Facilities ("SGS CHF") at the end of the lease term in April 2015.

Estimated Change in Non-Fuel Revenue Requirement

As indicated in Exhibit A (attached hereto), TEP projects that the Purchase Commitments, coupled with the termination of certain lease obligations at the Springerville Generating Station, will reduce the Company's non-fuel revenue requirement by $36 million.[2] However, when other changes to TEP's rate base, expenses and retail sales levels are considered, the Company projects that it will have a non-fuel revenue deficiency of $25.6 million[3] as of December 31, 2014.

The analysis herein is based on forecasts and estimates that may differ from the actual costs and data TEP would include if it were to file a formal rate application based on a December 31, 2014 test-year. However, certain rate-making assumptions used in the Company's analysis are consistent with the Settlement Agreement such as the authorized return on equity and the return on the fair value increment. Moreover, TEP updated its projected 2014 cost of debt and capital structure, which resulted in a *lower* rate of return on rate base than the amount approved by the Commission in the Settlement Agreement.[4]

SECTION 2 - TEP PURCHASE COMMITMENTS

Springerville Unit 1

SGS Unit 1 is a coal-fired generating station with a capacity of 387 megawatts (MW), located in Springerville, Arizona. TEP currently leases 85.9% of SGS Unit 1 from a group of five owner participants; the leases expire on January 1, 2015 and include fair market value purchase options. TEP owns the remaining 14.1%, representing approximately 55 MW of capacity.

In December 2011, TEP and the owner participants of SGS Unit 1 completed a formal appraisal procedure to determine the fair market value purchase price for the 85.9% of the unit not owned by TEP. The purchase price was determined to be $478 per kW of capacity, or approximately $159 million.

In 2013, TEP elected to purchase 35.4% of the unit from three of the five owner participants for $65 million (consistent with the appraisal result of $478 per kW). Combined with TEP's current ownership interest of 14.1%, the purchase will increase the Company's ownership interest in SGS Unit 1 to 49.5% (190 MW) upon the expiration of the leases on January 1, 2015. The remaining 50.5% of SGS Unit 1 (197 MW) will be owned by third parties.[5] TEP will continue to operate SGS Unit 1, but will no longer

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[2] See Exhibit A, page 2, column B
[3] See Exhibit A, page 2, column E
[4] See Section 4 - Assumptions
[5] The current third party owners are affiliates of Alterna Capital Partners and Fortress Investment Group LLC

have rights to the 197 MW owned by third parties. In addition to operating SGS Unit 1, TEP operates the other three generating units at the Springerville site.[6]

Based on agreements reached between TEP and the selling owner participants, a purchase price of $20 million will be paid to one owner participant in December 2014, while the remaining $45 million is scheduled to be paid to the other two owner participants in January 2015.

Gila River Unit 3 - Replacement Generating Resource for Springerville Unit 1

Beginning on January 1, 2015, upon the expiration of the SGS Unit 1 leases, TEP will need to replace the 197 MW of forgone capacity from SGS Unit 1.

As described in previously filed documents with the Commission[7] and in other public disclosures, TEP and UNS Electric, Inc. ("UNS Electric") entered into an agreement with a subsidiary of Entegra Power Group LLC to purchase Gila River Unit 3 for $219 million. Gila River Unit 3 is a combined cycle natural gas unit with a capacity rating of 550 MW, located in Gila Bend, Arizona.

TEP anticipates purchasing a 75% ownership interest in Gila River Unit 3 (413 MW) for approximately $164 million, while UNS Electric will purchase the remaining 25% (137 MW) for approximately $55 million. However, TEP and UNS Electric may modify the percentage ownership allocation between them. The transaction is expected to close in December 2014.

TEP's purchase of 75% of Gila River Unit 3 is expected to replace (i) the 197 MW of forgone coal-fired capacity from SGS Unit 1 and (ii) the expected reduction of 170 MW of coal-fired generating capacity from the San Juan Generating Station Unit 2.[8] The acquisition of Gila River Unit 3 is an integral component of TEP's strategy to diversify its generation fuel mix.

Springerville Coal Handling Facilities

TEP's other interests at the SGS site include a 13% ownership interest and an 87% lease interest in the SGS CHF. These facilities include a rail spur, a rotary rail car dumper, a coal conveyor system and other facilities needed to supply coal to the entire site. In 1984, TEP sold and leased back the SGS CHF. In 2001, TEP purchased a 13% ownership interest in the SGS CHF. The remaining leases covering 87% of the SGS CHF expire in April 2015 and include fixed-price purchase provisions.

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[6] San Carlos, Inc., a wholly-owned subsidiary of TEP, owns unit 2, Tri-State Generation and Transmission Association Inc. owns unit 3 and Salt River Project Agricultural Improvement and Power District owns unit 4

[7] These documents include: (i) an application filed by UNS Electric on December 31, 2013, requesting an accounting order for its anticipated purchase of up to 25% of Gila River Unit 3 (Docket No. E-04204A-1300476); (ii) a joint application filed by UNS Electric and UNS Gas on December 18, 2013, requesting a Financing Order (Docket No. E-04204A-130447), and (iii) TEP's and UNS Electric's 2014 Integrated Resource Plans filed with the Commission on April 1, 2014.

[8] TEP currently owns 50%, or 170 MW, of San Juan Unit 2. San Juan Unit 2 could be shut-down by December 31, 2017, according to a non-binding agreement between the state of New Mexico, the EPA and Public Service Company of New Mexico.

In April 2014, the Company notified the lessors of the SGS CHF that TEP had elected to purchase their undivided ownership interests in the facilities at the fixed purchase price of $120 million upon the expiration of the lease term in April 2015. Upon TEP's purchase, Salt River Project Agricultural Improvement and Power District ("SRP") is obligated to buy a portion of the facilities from TEP for approximately $24 million and Tri-State Generation and Transmission Association Inc. ("Tri-State") is obligated to either 1) buy a portion of the facilities for approximately $24 million or 2) continue to make payments to TEP for the use of the facilities. The Company expects SRP and Tri-State to purchase their respective ownership interests subsequent to TEP's purchase of the SGS CHF. As a result, TEP's net investment in the SGS CHF is expected to be approximately $73 million.

Summary of Purchase Commitments

Table 1 summarizes the Purchase Commitments referenced in section 10.1 of the Settlement Agreement.

Table 1 – TEP Purchase Commitments

Facility	Current Ownership Interest	Future Ownership Interest	Purchase Commitment	Purchase Date(s)
SGS Unit 1	14.1%	49.5%	$65 million	Dec. 2014 & Jan. 2015
SGS CHF	13.3%	65.9%	$73 million	April 2015
Gila River Unit 3	0.0%	75.0%	$164 million	Dec. 2014
Total Purchase Commitments			**$302 million**	

SECTION 3 - ESTIMATED RATE BASE AND REVENUE REQUIREMENT CHANGES

3.a. Amounts Included in Current Rates

For retail rate-making purposes, the leases for SGS Unit 1 and the SGS CHF are currently included in TEP's revenue requirement as operating leases; the amounts were based on the levelized lease payments for each respective lease. The lease payments represent a majority of the costs included in the non-fuel revenue requirement for SGS Unit 1 approved by the Commission in each of TEP's last two rate cases.

TEP's non-fuel revenue requirement and original cost rate base ("OCRB") also include amounts associated with leasehold improvements related to the SGS site. These leasehold improvements represent investments made by the Company to ensure that the SGS facilities continue providing safe, reliable service to TEP's customers. See Section 4 for more information related to SGS leasehold improvements.

Table 2 below summarizes the OCRB and non-fuel revenue requirement for the SGS Unit 1 and CHF leases and the SGS leasehold improvements included in TEP's current rates. For additional supporting detail, please see column D on Exhibit A, page 1 of 2.

Table 2 – Rate Base and Non-Fuel Revenue Requirement in Current Rates

Category	SGS Unit 1, SGS CHF and related leasehold improvements
Original Cost Rate Base	$87 million
Non-Fuel Revenue Requirement	$119 million

3.b. Estimated Rate Base Impact of Purchase Commitments

The impact on TEP's OCRB of (i) the Purchase Commitments, (ii) the rate base treatment of amounts paid for TEP's existing 14% share of SGS Unit 1 and 13% share of the SGS CHF, and (*iii*) the SGS leasehold improvements, is projected to be $415 million as of December 31, 2014. This represents an increase of $328 million relative to the OCRB reflected in TEP's current rates.[9] See Table 3 below. For additional supporting detail, please see columns A, B and C on Exhibit A, page 1 of 2.

Table 3 – Estimated Change in OCRB

$ in millions Description	12/31/11 Test Year Per Settlement	12/31/14 Test Year Estimated
SGS Unit 1[10]	$ 0	$100
SGS CHF[11]	0	86
SGS Unit 1 and CHF Leasehold Improvements	87	80
Total SGS Facilities	**87**	**266**
Gila River Unit 3	0	149
Total OCRB	**$87**	**$415**

3.c. Estimated Revenue Requirement of the Purchase Commitments

TEP's current rates include the recovery of $119 million of non-fuel costs for SGS Unit 1, the SGS CHF and related leasehold improvements.[12] The Company estimates that TEP's 2014 non-fuel revenue requirement associated with the Purchase Commitments and the SGS leasehold improvements is $83 million.[13] This implies a $36 million reduction to TEP's non-fuel revenue requirement.[14] This analysis,

[9] $328 million represents the ACC jurisdictional portion of the Purchase Commitments and the rate base treatment of amounts paid by TEP for existing ownership interests in SGS Unit 1 and the SGS CHF; for the purposes of this report, we allocated 89.92% to ACC jurisdictional rate base (consistent with the allocation approved in the Settlement Agreement).

[10] Balance at 12/31/14 includes ACC jurisdictional portion of $48 million paid for existing 14% ownership interest

[11] Balance at 12/31/14 includes ACC jurisdictional portion of $13 million paid for existing 13% ownership interest

[12] See Exhibit A, page 1, column D

[13] See Exhibit A, page 1, column C

however, does not include other cost of service changes that have occurred since December 31, 2011, which is the end of the test year used in TEP's most recent rate case. See Exhibit A for additional detail.

Table 4 – Comparison of Non-Fuel Revenue Requirement

$ in millions Description	12/31/11 Test Year Per Settlement	12/31/14 Test Year Estimated
SGS Unit 1, SGS CHF and Leasehold Improvements	$119	$56
Gila River Unit 3	0	27
Total Non-Fuel Revenue Requirement	**$119**	**$83**

3.d. Other Rate Base Additions

In addition to the Purchase Commitments, TEP is expecting to add approximately $114 million[15] (net of depreciation and accumulated deferred taxes) to its December 31, 2011 OCRB by the end of 2014. When combined with the $328 million increase in OCRB attributable to the Purchase Commitments,[16] SGS leasehold improvements and rate base treatment of previously acquired SGS ownership interests, TEP's total OCRB as of December 31, 2014 is expected to be $442 million higher than it was in December 2011.[17] This represents an increase of 29% compared with the December 31, 2011 OCRB reflected in TEP's current rates. See Table 5 below. For additional supporting detail on other rate base additions, please see column C on Exhibit A, page 2 of 2.

Table 5 – 2011 to 2014 OCRB Build-Up

$ in millions (Amounts net of depreciation and amortization)	OCRB
12/31/11 Test Year Per Settlement	**$1,507**
SGS Unit 1	100
Gila River Unit 3	149
SGS CHF	86
Change in SGS Leasehold Improvements	(7)
Other Rate Base Additions	114
12/31/14 Estimate	**$1,949**

[14] See Exhibit A, page 2, column E
[15] See Exhibit A, page 2, column C
[16] See Exhibit A, page 2, column B
[17] See Exhibit A, page 2, column D

3.e. Other Changes to TEP's Non-Fuel Revenue Requirement

Over the last three years, TEP's costs to provide safe, reliable service, and the revenues collected by the Company have been affected by the following:

- Ongoing utility system investments. TEP's December 31, 2014 OCRB is projected to be over $440 million higher than the 2011 OCRB approved in the Settlement Agreement.
- Rising costs. While the Company has implemented successful cost containment measures, TEP is experiencing general cost pressures across its business, such as labor and compliance costs.
- Lower retail sales volumes. TEP estimates that its 2014 retail kWh sales will be approximately 2% *below* 2011 levels.

As a result of these factors, as well as the previously described Purchase Commitments, TEP projects that it will *under-recover* non-fuel revenues by $25.6 million based on a 2014 projected test year.[18] Table 6 below provides a summary of this analysis. For additional supporting detail, please see Exhibit A, page 2 of 2.

Table 6 – Estimated Change in Non-Fuel Revenue Requirement: 2011 vs. 2014

$ in millions	Non-Fuel Revenue Requirement
2011 Non-Fuel Revenue Requirement Per Settlement	**$ 629**
Removal of SGS Unit 1 and SGS CHF Leases, and related Leasehold Improvements	(119)
Impact of Purchase Commitments and SGS Leasehold Improvements	83
Other Changes to Non-Fuel Revenue Requirement Between 2011 and 2014	45
Estimated 2014 Non-Fuel Revenue Requirement	**$ 638**
Current Projection of 2014 Non-Fuel Retail Revenues	**612**
Estimated Non-Fuel Revenue Requirement Deficiency	**$ 26**

SECTION 4 – ASSUMPTIONS

Key Assumptions

The analysis herein assumes a December 31, 2014 test year with pro forma adjustments to capture the full-year effect of the Purchase Commitments on TEP's rate base, operating expenses and resulting non-fuel revenue requirement.

As shown in Table 7 below, TEP's capital structure, cost of debt and income tax rates were updated to reflect current 2014 projections. The net effect of updating these assumptions reduced TEP's 2014 estimated non-fuel revenue requirement by approximately $3 million. The Company's analysis is based on forecasts and estimates that may differ from the actual costs and data TEP would include in a formal rate application based on a December 31, 2014 test year.

[18] See Exhibit A, page 2, column E

Table 7 – Key Assumptions

Assumptions	Settlement Agreement	2014 Compliance Report
Rate of Return on OCRB	7.26%	6.93%
Cost of Debt	5.18%	4.40%
Return on Equity	10.00%	10.00%
Return on Fair Value Increment	0.68%	0.68%
Total Debt / Capitalization	56.5%	54.8%
Total Equity /Capitalization	43.5%	45.2%
Income Tax Rate	39.6%	39.3%
Tax Gross-Up Factor	1.6590	1.6474

SGS Leasehold Improvements

The OCRB approved by the Commission in TEP's last rate case included SGS leasehold improvements of approximately $87 million (net of accumulated amortization). The approved amortization period was approximately 10 years.[19]

At December 31, 2014, the SGS leasehold improvements (net of accumulated amortization) are expected to be approximately $80 million. For purposes of this report, TEP extended the amortization period for the leasehold improvements associated with the portions of SGS Unit 1 and the SGS CHF that the Company will own.[20] The remaining leasehold improvements were assumed to remain on a 10-year amortization schedule, consistent with the treatment approved by the Commission in TEP's last rate case.

[19] Historically, TEP uses a "remaining life approach" for determining amortization periods for leasehold improvements. That approach was used in the TEP Settlement Agreement for leasehold improvements made to the SGS common facilities, since the lease term for those facilities expire in 2017 and 2021 (approximately 10 years from the test year used in that proceeding). However, for SGS Unit 1 and the SGS CHF, the rate impact of using amortization periods equal to the remaining lives of the leases would have been too great since both leases expire in early 2015. Therefore, 10 years was used.

[20] 30 years for SGS Unit 1 and 36 years for the SGS CHF.

EXHIBIT A

Tucson Electric Power Company
Analysis of Impact from Gila River Unit 3, SGS Unit 1 and Coal Handling Facilities Purchases

	A	B	C (A + B)	D	E (C+D)
	2014			2011	
	Gila River Unit 3 Purchase	SGS Unit 1 & CHF Purchases	Total	Termination of SGS Unit 1 & *CHF Leases* (Revenue Requirement in Settlement)	Change in Non-Fuel *Revenue Requirement* Gila River Unit 3 / SGS Unit 1 / CHF
Rate Base					
Production	$ 147,581	$ 271,412	$ 418,993	$ (95,759)	$ 323,235
Distribution	0	0	0	0	0
General	0	0	0	0	0
Net Plant Assets	147,581	271,412	418,993	(95,759)	323,235
Working Capital	4,164	5,207	9,371	(10,974)	(1,603)
Accumulated Deferred Income Taxes	(2,206)	(10,909)	(13,115)	19,474	6,359
Other	0	0	0	0	0
Total Rate Base	149,539	265,710	415,249	(87,258)	327,991
			0		
Cost of Capital			0		
Debt Cost	3,610	6,414	10,023	(2,539)	7,484
Return on Equity	6,758	12,008	18,766	(3,796)	14,970
Return on Rate Base	10,368	18,422	28,789	(6,335)	22,454
			0		
Fair Value Increment	514	913	1,426	(300)	1,126
			0		
Return on Rate Base including Fair Value Increment	10,881	19,334	30,215	(6,635)	23,581
			0		
Revenue - Expense			0		
O&M (Excluding Outages)	5,981	11,232	17,214	(102,161)	(84,947)
Depreciation	6,196	15,350	21,546	(8,533)	13,012
Outage Expense	2,206	1,138	3,344	(2,292)	1,052
Property Taxes	1,575	5,889	7,464	(3,289)	4,175
Income Taxes	4,708	8,365	13,073	(2,688)	10,385
Other Revenue	(4,800)	(5,186)	(9,986)	6,252	(3,734)
			0		
Net Operating Expense	15,866	36,788	52,655	(112,711)	(60,056)
			0		
Revenue Requirement (Non-Fuel)	$ 26,747	$ 56,123	$ 82,870	$ (119,346)	$ (36,476)

Note: Rate base values are as of year-end; 2014 amounts include pro forma *adjustments for the Purchase Commitments* that are expected to be made during 2015.

Tucson Electric Power Company

Analysis of Impact from Gila River Unit 3, SGS Unit 1 and Coal Handling Facilities Purchases

	A	B	C	D (C + D)	E (A + D)
		Change in Non-Fuel Revenue Requirement Impacts			
	2011 - Per Settlement	Gila River Unit 3 / SGS Unit 1 / CHF	Other Changes	Total	2014 Estimated Revenue Requirement
Rate Base					
Production	$ 873,103	$ 323,235	$ 124,798	$ 448,032	$ 1,321,135
Distribution	719,476	0	122,605	122,605	842,081
General	195,234	0	11,680	11,680	206,914
Net Plant Assets	1,787,813	323,235	259,082	582,317	2,370,130
Working Capital	52,400	(1,603)	16,074	14,471	66,871
Accumulated Deferred Income Tax	(284,654)	6,359	(161,482)	(155,123)	(439,777)
Other	(48,499)	0	408	408	(48,091)
Total Rate Base	1,507,060	327,991	114,083	442,073	1,949,133
				0	
Cost of Capital				0	
Debt Cost	43,807	7,484	(4,244)	3,240	47,047
Return on Equity	65,557	14,970	7,558	22,529	88,086
Return on Rate Base	109,364	22,454	3,314	25,769	135,133
		0		0	
Fair Value Increment	5,176	1,126	392	1,518	6,694
				0	
Return on Rate Base including Fair Value Increment	114,540	23,581	3,706	27,287	141,827
				0	
Revenue - Expense				0	
O&M (Excluding Outages)	365,850	(84,947)	28,390	(56,557)	309,293
Depreciation	98,830	13,012	4,374	17,386	116,216
Outage Expense	11,590	1,052	4,453	5,505	17,095
Property Taxes	30,731	4,175	(2,845)	1,330	32,061
Income Taxes	46,702	10,385	4,278	14,663	61,365
Other Revenue	(38,782)	(3,734)	2,552	(1,182)	(39,964)
Net Operating Expense	514,921	(60,056)	41,203	(18,854)	496,067
Revenue Requirement (Non-Fuel)	$ 629,461	$ (36,476)	$ 44,909	$ 8,433	637,894
Non-Fuel Retail Revenue (est. 2014)					612,238
Revenue Deficiency					$ 25,656