

CARL J. KUNASE
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER



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BRIAN C. McNEIL
EXECUTIVE SECRETARY

ARIZONA CORPORATION COMMISSION

DATE: NOVEMBER 26, 1999

DOCKET NO: E-01933A-99-0573

TO ALL PARTIES:

Enclosed please find the recommendation of Hearing Officer Jane Rodda. The recommendation has been filed in the form of an Order on:

TUCSON ELECTRIC POWER COMPANY
(FINANCING)

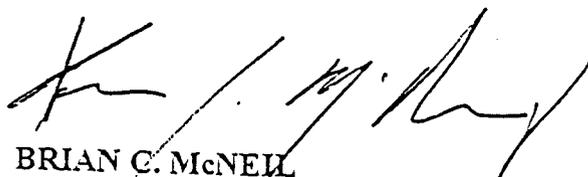
Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Hearing Officer by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by 10:00 a.m. on or before:

DECEMBER 6, 1999

The enclosed is NOT an order of the Commission, but a recommendation of the Hearing Officer to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

DECEMBER 7, 1999 and DECEMBER 8, 1999

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.


BRIAN C. McNEIL
EXECUTIVE SECRETARY

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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF
TUCSON ELECTRIC POWER COMPANY FOR A
FINANCING ORDER AUTHORIZING
AMENDMENTS TO THE SPRINGERVILLE
COMMON FACILITIES LEASES.

DOCKET NO. E-01933A-99-0573

DECISION NO. _____

ORDER

Open Meeting
December 7 & 8, 1999
Phoenix, Arizona

BY THE COMMISSION:

On October 8, 1999, Tucson Electric Power Company ("TEP" or "Company") filed with the Arizona Corporation Commission ("Commission"), an application seeking approval of certain financing transaction. Specifically, TEP has requested authority to either refinance the secured notes ("Lease Debt") underlying the Company's Springerville Common Facilities leases ("Leases"), and/or to restructure the Leases, which involves retiring all or a portion of the Lease Debt. On November 19, 1999, the Commission's Utilities Division Staff ("Staff") filed its Staff Report in which it recommended that the application be approved without a hearing.

Background

TEP is a subsidiary of UniSource Energy Corporation. TEP is an Arizona corporation with its principal office located in the City of Tucson, Arizona. It owns and operates facilities for the generation, purchase, transmission, distribution and sale of electricity to 324,000 customers in the City of Tucson and surrounding Pima County area and Fort Huachuca in Cochise County.

In 1985, TEP sold its undivided one-half ownership interest in the common facilities at its Springerville Generating Station to three owner participants for an aggregate purchase price of \$132 million. The owner participants provided approximately \$26 million of the purchase price and Lease Debt participants provided the remaining \$106 million. Originally, the Lease was scheduled to mature on December 31, 1992, and was intended to be bridge financing until the completion of the

1 sale and leaseback of the Springerville Unit 2. TEP's deteriorating financial condition prevented the
2 consummation of the sale and leaseback of the Springerville Unit 2.

3 In January 1991, the Company instituted a payment moratorium on certain credit and supply
4 agreements and contracts, including the Leases. The Commission approved TEP's restructuring plan
5 in Decision No. 58024 (September 16, 1992), which included a restructure of the Springerville
6 Common Facilities leases. This restructuring capitalized the accrued interest on the Lease Debt and
7 extended the term of the Lease Debt, with no change to the variable interest rate, provided that, if the
8 Lease Debt is not refinanced by 2000, the leases would terminate and TEP would be required to
9 purchase the common facilities for an amount equal to the higher of the stipulated loss value of \$144
10 million or the fair market value of the facilities.

11 To avoid the special event of loss" under the Lease and having to repurchase the facilities,
12 TEP must refinance or refund the Lease Debt by December 31, 1999. If any of the notes underlying
13 the Leases are outstanding on January 1, 2000, the owner participants would be deemed Holding
14 Companies under the Public Utility Holding Company Act. In order to prevent the owner
15 participants from being regulated as Utility Holding Companies, the Lease contract provides certain
16 protections to the owner participants, including the special event of loss and the requirement that TEP
17 refinance the Lease Debt rather than the owner participants.

18 Based on the current amortization schedule for the Secured Notes, a principal amount of
19 approximately \$70 million will be outstanding as of December 31, 1999. Interest on the Secured
20 Notes is currently equal to the Federal Funds rate plus 0.625 percent, determined semi-
21 annually (currently 5.88 percent).

22 Financing Alternatives

23 Refinancing of Lease Debt

24 One option available to TEP is to refinance the Lease Debt by either the sale of lease
25 obligation bonds to investors or by obtaining loans from one or more financial intermediaries.
26 Regardless of the term, the interest rate on the new debt will likely be higher than the current variable
27 interest rate (Federal Funds rate plus 0.625 percent) which will result in TEP paying higher rents.
28 TEP states that the interest rates on new lease debt will be a function of (1) market conditions at the

1 time of the refinancing, (2) the lender's view of TEP's creditworthiness, and (3) the lender's
2 evaluation of the leased assets which serve as collateral for the secured notes. TEP noted in its
3 application that under TEP's Stranded Cost Settlement Agreement, approved by the Commission in
4 Decision No. _____ (November __, 1999), any higher financing costs resulting from the refinancing
5 would not result in an increase in overall rates to retail customers, at least through 2008.

6 A refinancing would require amending the existing indentures creating a new series of
7 secured notes and amending the leases to adjust the rent payable to reflect the new debt service
8 requirements of the new series of secured notes. The change in rent payments will primarily be
9 affected by the change in debt service, but will also be adjusted to preserve the owner participants'
10 economics, including after-tax yield and after-tax cash flows.

11 Section 467 Lease Restructuring

12 TEP's second, and preferred, option is to take advantage of new Internal Revenue Service
13 ("IRS") regulations under section 467 of the Internal Revenue Code, by seeking to restructure the
14 leases to mitigate the higher cost of new lease debt. Under a restructure of the leases, TEP would
15 reduce the future net cost of the leases by making advanced rent payments which the lessor would
16 apply to the repayment of the lease debt. Pursuant to IRS regulations promulgated in May 1999,
17 under certain circumstances, a lessee and lessor can specify dates on which advanced payments of
18 rent are deemed to have been paid, notwithstanding an earlier payment of cash. This permits the
19 lessors (owner participants) to avoid recognizing the advance payment as income until the deemed
20 payment date. For income tax purposes, the advance payments to lessors are considered to be loans
21 from the lessee (TEP) to the lessors, with repayment of the loans taking the form of lower net rental
22 payments in later years.

23 Under this alternative, TEP expects that the leases would be amended to provide an actual
24 schedule of rent payments and a deemed, or allocated schedule of rent payments. TEP anticipates
25 that large cash payments of rent, sufficient to retire the lease debt, would be made either at year-end
26 or within the next year and that subsequent payments of rent would be greatly reduced. For income
27 tax purposes, rent will be deemed to have been paid based on an allocated rent schedule over the
28 terms of the leases. The owner participants would benefit from reduced credit exposure to TEP and

1 the elimination of their subordination to the Lease Debt. In return, TEP would expect reduced rent
2 payments in subsequent years. TEP may also be able to negotiate additional purchase options and the
3 right to assign the lease obligations to third parties meeting certain criteria without recourse to TEP.

4 Staff's Financial Analysis

5 Because TEP has not yet finalized its planned refinancing, in performing its analysis, Staff did
6 not know the ultimate cost of TEP's refinanced Lease Debt. According to Staff, factors that will
7 influence the cost of debt will be maturity, seniority, security, floating vs. fixed rates, repayment
8 provisions, ratings, and market forces. Based upon TEP's credit rating, the current average return on
9 medium grade utility bonds, current market rates, TEP's highly leveraged capital structure, and its
10 TIER ("Times Interest Earned Ratio") of 1.35¹ (based on 1998 figures), Staff assumed an interest rate
11 of 9.0 percent on the proposed refinancing in the first alternative. Under Staff's analysis, if TEP
12 refinanced the Lease debt over 20 years at an interest rate of 9.0 percent, it would incur additional
13 annual interest expense of approximately \$1.5 million (based on 1998 actual interest expenses).²

14 In analyzing TEP's second alternative, Staff noted that TEP had a 1998 year-end cash and
15 cash equivalent balance of \$118 million, which Staff believed would be adequate to make advanced
16 cash payments of rent sufficient to retire the \$70.0 million of outstanding Lease Debt. Staff also
17 noted that TEP has a \$100 million Revolving Line of Credit available.

18 Staff believed that the advanced cash payment alternative would be preferable because it
19 would result in an improved financial position. TEP informed Staff that it too would prefer this
20 alternative, but when it filed its application, was not sure whether the owner participants would be
21 willing to accept it.

22 Effect of Lease Debt on Rates

23 For rate-making purposed these leases are treated as operating leases, and thus have no impact
24 on the Company's capital structure, its cost of debt, or its weighted average cost of capital. The lease
25 payments do affect the income statement, and higher financing costs could result in higher rates to

26 _____
27 ¹ A TIER of at least 1.5 is preferred.

28 ² Because the current Lease Debt has a floating interest rate equal to the Federal Funds rate plus 0.63 percent, the additional cost to TEP as a result of the refinancing would be the difference between the new interest rate and the Federal Funds rate plus 0.63 percent.

1 customers.

2 Neither TEP nor Staff expected the higher lease costs to affect rates. The assets associated
3 with the Springerville common facilities will be designated as competitive assets and transferred to a
4 separate subsidiary no later than December 2002. As a result of TEP's Stranded Cost proceeding,
5 rates to Standard Offer customers will be frozen through December 2008. Staff also believed that the
6 proposed refinancing will result in, at most, a 1.30 percent increase over the 1998 Capital Lease
7 Expense.

8 We note that an increase in lease expense may not result in increased rates through 2008
9 because of the settlement we approved in TEP's Stranded Cost proceeding, but increased expenses
10 may affect the magnitude of any potential rate decrease that could arise as a result of the rate case
11 TEP is required to file in 2004. We recognize, however, that any increase in lease expense is
12 minimal, and is preferable to allowing TEP to incur a special event of loss and be required to
13 purchase the leased assets at a minimum of \$144 million. Consequently, we will approve TEP's
14 finance request as presented in its application. Although we do not know the exact terms of the
15 refinanced debt, TEP will be required to act in a prudent and reasonable manner to insure any future
16 effect on ratepayers is minimized. We also want to make it clear that the impact resulting from this
17 refinancing will not be considered as an emergency pursuant to Section 13.4 of the TEP Settlement
18 Agreement. As always, our approval of this financing request in no way binds this or any future
19 Commission to find the refinanced or restructured lease expenses to be reasonable.

20 * * * * *

21 Having considered the entire record herein and being fully advised in the premises, the
22 Commission finds, concludes, and orders that:

23 **FINDINGS OF FACT**

24 1. TEP, an Arizona corporation, is a subsidiary of UniSource Energy Corporation with
25 its principal office located in the City of Tucson, Arizona. It owns and operates facilities for the
26 generation, purchase, transmission, distribution and sale of electricity to 324,000 customers in the
27 City of Tucson and surrounding Pima County area and Fort Huachuca in Cochise County.

28 2. On October 8, 1999, TEP filed with the Commission an application seeking approval

1 to either refinance the secured notes underlying the Leases, or restructure the Leases, including a
2 retirement of all or a portion of the Lease Debt, or a combination of both alternatives.

3 3. TEP requested expedited consideration of its application because it must refinance the
4 Leases prior to the end of 1999. On November 24, 1999, TEP filed a letter with the Commission that
5 requested the application be considered at the Commissions December 7, 1999 Open Meeting and
6 waived its right pursuant to A.A.C. R14-3-110.B to be provided ten days to file any exceptions.

7 4. On November 19, 1999, Staff filed its Staff Report in which it recommended that the
8 application be approved without a hearing.

9 5. On November 24, 1999, TEP provided notice of the application to its customers by
10 publishing notice in the Arizona Daily Star and Tucson Citizen newspapers.

11 6. In 1985, TEP sold its one-half ownership interest in the common facilities at its
12 Springerville Generating Station to the owner participants. The purchase was financed by a
13 combination of equity and Lease Debt. Originally, the Lease Debt was scheduled to mature on
14 December 31, 1992, and was intended to be bridge financing until the completion of the sale and
15 leaseback of the Springerville Unit 2. TEP's deteriorating financial condition prevented the
16 consummation of the sale and leaseback of the Springerville Unit 2. In January 1991, the Company
17 instituted a payment moratorium on certain credit and supply agreements and contracts, including the
18 Springerville Common Facilities leases.

19 7. On September 16, 1992, the Commission issued Decision No. 58024, approving
20 TEP's restructuring plan, including a restructuring of the Leases.

21 8. The restructuring capitalized the accrued interest on the Lease Debt and extended the
22 term of the Lease Debt. In addition, under the terms of the restructured Leases, TEP must refinance
23 or refund the Lease Debt by December 31, 1999, or suffer "a special event of loss" which would
24 terminate the Leases and require TEP to repurchase the facilities for a price equal to the higher of
25 \$144 million or the fair market value.

26 9. As of December 31, 1999, the outstanding principal on the Lease Debt will be
27 approximately \$70 million.

28 10. Interest on the Lease Debt is paid at a variable rate of interest equal to the Federal

1 Funds rate plus 0.625 percent. Under current market rates this equates to 5.88 percent.

2 11. TEP plans to either refinance the Lease Debt or restructure the Leases to take
3 advantage of new regulations promulgated under Section 467 of the Internal Revenue Code.

4 12. The new regulations issued under Section 467 of the Internal Revenue Code permit a
5 lessee and lessor under certain circumstances to specify dates on which the rent is deemed to have
6 been paid and allow the lessor to avoid recognizing the advance payment as income until the deemed
7 payment date. The benefit of this option is that the owner participants would reduce their credit
8 exposure to TEP and eliminate their subordination to the Lease Debt and TEP would in turn negotiate
9 lower rent payments.

10 13. If TEP refinances the Lease Debt, the terms will be determined by the market
11 conditions and TEP's financial condition at the time of the transaction.

12 14. In Decision No. ____, the Commission approved TEP's settlement of its Stranded
13 Cost proceeding. Pursuant to Decision No. _____ TEP's rates may not be increased prior to
14 December 31, 2008.

15 15. In addition to recommending approval of the refinancing of the Lease Debt and/or
16 restructuring of the Leases, Staff recommended that TEP be permitted to make substantial
17 modifications to the Leases in order to comply with Section 467 of the Internal Revenue Code and
18 that the Company file with the Commission copies of all executed financing, restructuring, or
19 retirement documents setting down the terms of the agreement with each of the owner participants as
20 soon as they become available.

21 CONCLUSIONS OF LAW

22 1. TEP is a public service corporation within the meaning of Article XV of the Arizona
23 Constitution and A.R.S. §§40-301 and 40-302.

24 2. The Commission has jurisdiction over TEP and the subject matter of the application.

25 3. TEP caused notice of the application in this matter to be duly published in newspapers
26 of general circulation within its service territory.

27 4. Staff's recommendations as set forth in Findings of Fact No. 15, are reasonable and
28 should be adopted.

1 IT IS FURTHER ORDERED that approval of the financing set forth hereinabove does not
2 constitute or imply approval or disapproval by the Commission of any particular expenditure of the
3 proceeds derived thereby for purposes of establishing just and reasonable rates.

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ____ day of _____, 1999.

BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT _____

JR:dap

1 SERVICE LIST FOR:

TUCSON ELECTRIC POWER COMPANY

2 DOCKET NO.

DOCKET NO. E-01933A-99-0573

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