

THIS AMENDMENT:		
_____ Passed _____	Passed as amended by _____	
_____ Failed	_____ Not Offered	_____ Withdrawn

SPITZER PROPOSED AMENDMENT #1

TIME/DATE PREPARED 4:30 p.m. / December 15, 2004

COMPANY: UNISOURCE ENERGY CORPORATION (REORGANIZATION) AGENDA ITEM NO. 1

DOCKET NO. E-04230A-03-0933 OPEN MEETING:DATE: December 20-21, 2004

Page 20, Line 3, INSERT

"After issuance of the Recommended Opinion and Order, UniSource filed exceptions proposing: 1) Acceptance by UniSource of all of the conditions proposed by Staff, including those it was not willing to accept at Hearing; 2) Changes to the structure of the limited partnership; 3) the expenditure of \$10 million between 2005 and 2008 for "new programs" relating to demand side management; and 4) the expenditure of \$2.5 million as additional "charitable contributions". UniSource's attorneys also provided to the Commission and placed in the record an executive summary of the Ernst and Young Report discussed below."

Analysis and Resolution

Page 29, Line 12, after "perspective", INSERT

"We believe the Commission must balance the equities based upon this perspective, and the facts and circumstances of this specific proposal."

DELETE Page 31, Line 9 through Page 37, Line 7, and INSERT

"This transaction raises certain risks. The 43 conditions proposed by Staff address these risks, but further inquiry is required to properly evaluate this proposed transaction. We believe the most substantial risk and the crux of this case is the increased leverage above the operating company level. The Commission's concern is that the investors may be tempted to increase their return from utility operations by "cutting costs", thereby jeopardizing service quality.

As discussed below, the solution to this potential risk is for the Commission to impose strict service quality performance metrics upon all of the utility operating companies. The Commission must not be reactive, but instead anticipate potential risks to ensure service quality, particularly reliability. The service quality standards proposed herein represent a benefit of this transaction.

The parties to this case have focused a great deal on the potential risks inherent in a private equity investment in a regulated utility, and rightly so. However, the record reflects risks inherent in the status quo. Thoughtful evaluation of the merits of the proposed transaction compel the Commission to evaluate, contrast and ultimately balance the risks of UniSource's present circumstances with those it proposes to assume.

Seventy percent of UniSource's stock is currently held by institutional investors located outside Arizona. Fund managers are increasingly oriented towards short term financial results. Hedge funds speculate on the volatility of UniSource's publicly traded stock, up and down, short and long. The federal Sarbanes-Oxley legislation imposes strict financial and accounting compliance measures, and these expenses bear heavily on a small cap company. One consequence of the "Global Settlement" achieved between state and federal securities regulators and the securities industry is that "sell side" stock analysis of UniSource has declined. Economic pressure imposed by hedge funds and institutional investors owning, selling or short-selling UniSource stock is a current risk.

UniSource's management group spends a great deal of time and resources dealing with fund managers, time which could be more productively spent achieving costs savings and increased service reliability, particularly in UniSource's newly acquired service territories.

UniSource invests in non-regulated renewable energy technologies. These investments have generated operating losses flowing up to the holding company level. UniSource's institutional investors suggest that UniSource dispose of its renewable energy investments to stanch those losses and "increase shareholder value". Mr. Pignatelli and Mr. Rentschler testified that private equity is a superior vehicle for investments in renewables, due to the longer time horizon of private equity investors. In response to Commissioners' inquiries, Mr. Pignatelli agreed to continue investment in renewables if this transaction closes.

Mr. Pignatelli and his management group have received praise from *all* parties to this case. However, the chronology depicted herein indicates prior management did not perform as well as Mr. Pignatelli's leadership team. The departure of the current management, both long and short term, is a risk of the status quo. This proposed transaction poses a greater assurance of continuity.

Out into the future, both management continuity and performance are current risks. Legislatively mandated market, financial and regulatory matters, including environmental expenditures, are current risks.

The Commission observes Hearing testimony regarding the possibility of a "takeover" of UniSource by a third party. The Commission takes judicial notice of the "Affiliated Interest" rules vesting the Commission with authority over a subsequent consensual transaction, assuming this proposal fails. However, the Affiliated Interest rules do not extend to tender offer stock acquisitions by third party or parties. Assuming UniSource's witnesses are correct that its stock is undervalued by the market, third parties could obtain voting control of UniSource's outstanding stock and potentially control over management through the election of directors. Mr. Antonuk's testimony indicates the 1935 Public Utility Holding Company Act ("PUHCA") is subject to repeal by Congress. Mr. Antonuk believes PUHCA is not an effective deterrent to

corporate acquisition even it remains part of federal law. A "hostile" as opposed to consensual change in ownership is a risk of the status quo.

Small cap companies often have difficulty obtaining capital. UniSource's debt is presently below investment grade. Many purchasers of corporate debt are institutionally precluded from investing in non-investment grade debt. This further constricts capital flow to UniSource, and represents a risk of the status quo. The record reflects that the investors have greater access to the capital markets than does UniSource.

The transaction as proposed by the Applicant causes the Commission concern, beyond Staff's aforementioned unease, about the future service quality of the utilities currently operated by UniSource. Our analysis concludes that an inherent weakness with a proposed leveraged buyout of a utility(s), or its holding company, is that it may result in the new owners' desire to cut costs of the utility(s) and transfer such savings to the new owners or other stakeholders. We are concerned such a desire will become a reality and that cutting costs will have a direct impact in reducing or impairing the reliability of the utilities' services. This concern is exacerbated by the current growth experienced by these utilities throughout their service territories. The increase in customers will compel those utilities to make capital expenditures to fund the facilities needed to accommodate such growth. This may cause the utilities to choose between funding growth or funding operations and maintenance within their existing systems. That situation may pressure the utilities to cut costs to fund the growth, thus potentially jeopardizing service quality, particularly reliability.

The Commission intends that this transaction enhance rather than imperil the safe and reliable service of the utilities currently operated by UniSource. Additional quality of service benefits should inure to the current and future customers of TEP, UNS Electric and UNS Gas. Therefore, as a condition of approval, we will require that the utilities adhere to strict service quality standards based upon objective criteria as well as a restriction regarding the use of funds from the lines of credit established by UniSource, and its affiliates.

The record raises concerns regarding the appropriateness of a limited partnership as an investment vehicle for a utility holding company. We believe Saguaro LP should be constituted as a corporation rather than as a limited partnership or limited liability company. The transparency and nature of the corporate form, appropriate for Saguaro Holdings, is also appropriate for Saguaro LP. For purposes of this Decision, we will also refer to the new corporate entity of Saguaro L.P. as Saguaro Utility Corp.

We believe the equities of this case require a contribution by the investors to UniSource "above and beyond" that initially proposed. The investors' infusion of an additional \$50 million to UniSource is proper given the contribution of the company's ratepayers, employees, and the southern Arizona community, to its economic recovery during the past ten years."

As stated above, Saguaro LP proposed paying \$1.2 billion (\$556.7 million in equity and \$660 million in debt) to acquire UniSource and infuse cash into TEP. Based upon the threat of increased financial leverage, the need to balance the monetary rewards to the investors with the risks of investment and to increase the ability of the utilities to attract capital at more fair and reasonable terms, we arrive at the conclusion that a further equity infusion of \$50 million into

TEP, UNS Electric and UNS Gas, through UniSource, is a necessary condition for our approval of this transaction.

The source of funds for the equity infusion cannot be in the form of debt from Saguaro LP/Saguaro Utility Corp. as that would simply result in a greater debt leveraging of Saguaro LP/Saguaro Utility Corp. Rather, we will require that the \$50 million infusion must be paid to UniSource from KKR, JPMP and/or WCP with the percentage of contribution amounts to be determined by those three entities.

The new transaction valued at 1.25 billion (\$601.7 million in equity and \$660 million in debt) mitigates our concerns about the financial status of UniSource and its affiliates. It also more appropriately balances the risk and the rewards of the investors. Further, UniSource's argument that the proposed transaction would allow the utilities to attract capital on fair and reasonable terms is more compelling. UniSource claimed a benefit of the transaction as originally proposed was that the financially-improved TEP would be in a better position to negotiate terms and conditions when acquiring necessary capital essentially because TEP would obtain a capital structure of 40% equity and 60% debt. We feel that those same benefits should accrue to UNS Electric and UNS Gas and their customers. While we are cognizant of the revolving loans afforded to UNS Electric and UNS Gas, we feel that the growth within their service territories demands that their capital structures be improved.

Currently UNS Electric's capital structure is 36% equity, 63% debt and 1% capital lease obligation, while UNS Gas has a capital structure of 35% equity and 65% debt. In order to raise UNS Electric's and UNS Gas' capital structure to approximately the same as TEP's, we find that an equity infusion of \$10 million each is necessary. Therefore, TEP, UNS Electric and UNS Gas shall, at a minimum, receive at least a \$10 million each from UniSource from the additional \$50 million in equity contributions made by KKR, JPMP and/or WCP. UniSource shall determine the specific amounts that each utility will receive in equity contributions in excess of the \$10 million floor until the \$50 million is exhausted. If the \$10 million floor creates a hardship for UniSource or its affiliates, it may petition the Commission to review this condition and the Commission may consider such a request. However, the Commission will not entertain a request to reduce the \$50 million figure as that equity infusion into UniSource is necessary to approve this transaction.

UniSource filed Exceptions to the Recommended Opinion and Order, among other things, stating it would fund \$10 million for Commission approved uses, such as new programs for demand side management, weatherization, and low income assistance between 2005 and 2008. We concur. In its exceptions, UniSource agreed to abide by all of Staff's conditions set forth in Exhibit C. We agree with Staff that all of the conditions set forth in Exhibit C are necessary for us to approve this transaction, except that, as stated above, Saguaro L.P. should be an incorporated entity and that Section (D)(12) and (13) shall be deleted and language delineated in Exhibit D shall be inserted. Therefore, we will order that the Applicant and Saguaro Utility Corp. shall comply with the recommendations in Exhibit C as amended by Exhibit D as a condition of our approval.

DELETE Page 38, Line 13 through Page 40, Line 3, and INSERT

"Commissioners Mayes and Mundell also raised the discovery of internal rate of return studies performed by the individual investors ("IRR studies"). Whereas the E & Y report was part of a "due diligence" review of a proposed transaction and was based upon UniSource's rate review data, the IRR studies are based upon the investors' internal and generic transaction-evaluation metrics.

Discovery of the E & Y report and the IRR studies balances the probative value of the evidence against competing considerations, including proprietary concerns and potential prejudice to a future rate proceeding. From the clairvoyance of hindsight, the E & Y report should have been produced. It has probative value. For example, RUCO's argument that a future rate proceeding could stress the operating companies is based upon speculation that TEP is currently over earning.

Although the filing of the executive summary of the E & Y report does not completely cure nor resolve the discovery matter, the amendments proposed herein mitigate RUCO's legitimate and well-expressed concern over holding company leverage and the risks associated therein. The further ring fencing and bankruptcy protections, the additional \$150 million in capital and most importantly, the proposed service quality metrics, effectively moot this issue. Assuming *arguendo* TEP is over earning, and that a future rate proceeding would reduce its rates, the dangers to the operating and holding companies are far more severe under the status quo than to a stronger, less-leveraged and better capitalized company resulting from approval of the transaction with this amendment. Moreover, this transaction shifts the risks of a future rate proceeding from the ratepayers to the investors.

The IRR studies pose a less compelling case for discovery. Their probative value is more tenuous and the nature of the analyses comport greater proprietary value. Whereas the E & Y report directly deals with TEP rates, the IRR studies reflect how the investors evaluate potential equity transactions. The former directly relates to concerns expressed by the parties to this case, Commissioners and UniSource's ratepayers. The IRR studies, less so. Again, we believe that with these proposed amendments, risks embedded in whether TEP is under or over earning are largely shifted from ratepayers to the investors, another aspect of the benefits of the transaction to those ratepayers. Although UniSource did not properly deal with the discovery of the E & Y report at Hearing, the over earning matter imposes risks upon UniSource irrespective of the disposition of this proceeding and is best and ultimately resolved in a rate case."

Summary

DELETE Page 40, Line 5 through Line 26, and INSERT:

"In evaluating this proposed transaction, it is very important to consider what it is not. While undertaken for the first time in Arizona, private equity investors have acquired businesses heavily regulated by government and even regulated public utilities in other states. The proposed transaction is not therefore legally or economically unique.

A nugget from the record is that a private equity acquisition is a substitution of one cadre of institutional investors for another. TR at 426. **All** investments incur risks. No amount of regulation or advance planning can account for every contingency nor eliminate all risk.

The record, and indeed the history of TEP, reveals spectacular failures of publicly traded utilities. UniSource has great risk and limited access to capital under the status quo. The protections advocated by Staff, and adopted herein, provide a greater degree of protection to ratepayers than does the status quo. The reorganized entities will have stronger balance sheets, more capital, less debt, greater access to capital and enhanced funding for important energy-savings. The service quality provisions only enhance these benefits. A lower cost of capital reduces upward pressure on rates at a time when the cost of fossil fuels is trending higher. And the reorganized UniSource will be more likely to resist either a hostile takeover or a demand to divest the renewable investments contained within Millennium.

The question is not whether private equity transactions are inherently good or bad. The question in this case is whether this transaction, as amended herein, reduces ratepayer risk and produces ratepayer benefits consistent with the public interest. Today the Commission resolves the greatest risk, service quality, productively. This Commission, based upon these facts, resolves the question in favor of the proposed transaction with these amendments.

FINDINGS OF FACT

Page 46, Line 30, DELETE Findings of Fact 40 through 51, INSERT:

‘Finding of Fact 40. On November 8, 2004, the Recommended Opinion and Order was issued by the Hearing Division.

Finding of Fact 41. After issuance of the Recommended Opinion and Order, UniSource filed exceptions proposing: 1) Acceptance by UniSource of all of the conditions proposed by Staff, including those it was not willing to accept at Hearing; 2) Changes to the structure of the limited partnership; 3) \$10 million between 2005 and 2008 for "new programs" relating to demand side management; and 4) \$2.5 million in additional "charitable contributions". UniSource's attorneys also provided to the Commission and placed in the record an executive summary of the Ernst and Young Report discussed below.

Finding of Fact 42. Saguario LP should be organized as a corporation rather than as a limited partnership. We will refer to this new corporate entity as Saguario Utility Corp.

Finding of Fact 43. UniSource filed exceptions to the Recommended Opinion and Order, among other things, stating it would fund \$10 million for Commission approved uses, such as new programs for demand side management, weatherization, and low income assistance between 2005 and 2008. We concur.

Finding of Fact 44. In its exceptions, UniSource agreed to abide by all of Staff's conditions set forth in Exhibit C. We agree with Staff that all of the conditions set forth in Exhibit C are necessary for us to approve this transaction, except that, as stated above, Saguario L.P. should be

an incorporated entity and that Section (D)(12) and (13) shall be deleted and language delineated in Exhibit D shall be inserted. Therefore, we will order that the Applicant and Saguaro Utility Corp. shall comply with the recommendations in Exhibit C as amended by Exhibit D as a condition of our approval.

Finding of Fact 45. Our analysis concludes that an inherent weakness with a proposed leveraged buyout of a utility(s), or its holding company, is that it may result in the new owners' desire to cut costs of the utility(s) and transfer such savings to the new owners or other stakeholders. This concern is exacerbated by the current growth experienced by TEP, UNS Electric, and UNS Gas throughout their service territories. Those situations may pressure the utilities to cut costs to fund the growth or transfer the savings to the investors, thus potentially jeopardizing service quality, particularly reliability.

Finding of Fact 46. The Commission intends that this transaction enhance rather than imperil the safe and reliable service of the utilities currently operated by UniSource. Additional quality of service benefits should inure to the current and future customers of TEP, UNS Electric and UNS Gas. Therefore, as a condition of approval, we will require that the utilities adhere to strict service quality standards based upon objective criteria as well as a restriction regarding the use of funds from the lines of credit established by UniSource, and its affiliates.

Finding of Fact 47. Consistent with our discussion above, we believe the equities of this case require a contribution by the investors to UniSource "above and beyond" that initially proposed. Based upon the threat of increased financial leverage, the need to balance the monetary rewards to the investors with the risks of investment and to increase the ability of the utilities to attract capital on more fair and reasonable terms, we arrive at the conclusion that a further equity infusion of \$50 million into TEP, UNS Electric and UNS Gas, through UniSource, is a necessary condition for our approval of this transaction.

Finding of Fact 48. In order to raise UNS Electric's and UNS Gas' capital structure to approximately the same as TEP's, we find that an equity infusion of \$10 million each is necessary. Therefore, TEP, UNS Electric and UNS Gas shall, at a minimum, receive at least a \$10 million each from UniSource from the additional \$50 million in equity contributions made by KKR, JPMP and/or WCP. UniSource shall determine the specific amounts that each utility will receive in equity contributions in excess of the \$10 million requirement per utility until the \$50 million is exhausted.

Finding of Fact 49. The source of funds for the equity infusion cannot be in the form of debt from Saguaro Holdings and/or Saguaro L.P./Saguaro Utility Corp. as that would simply result in a greater leverage to Saguaro Holdings and/or Saguaro L.P./Saguaro Utility Corp. Rather, we will require that the \$50 million infusion must be paid to UniSource from KKR, JPMP and/or WCP with the percentage of contribution amounts to be determined by those three entities.

Finding of Fact 50. UniSource's debt is currently non-investment grade. This transaction as modified herein will increase UniSource's access to capital, particularly lower cost debt.

Finding of Fact 51. In this transaction, UniSource in effect exchanges one set of institutional investors for another. The proposed reorganization of UniSource, as amended herein, provides tangible benefits to the ratepayers of the operating companies.

Finding of Fact 52. No transaction is free of risk. The proposed transaction contains risks of various types, as does the status quo. The conditions agreed to by the investors and UniSource reduce the company's (and its subsidiaries') risk profile.

Finding of Fact 53. The proposed transaction, as amended herein, is in the public interest."

CONCLUSIONS OF LAW

Page 48, Line 19, DELETE Conclusions of Law 9 and 10, INSERT:

"Conclusion of Law 9. As amended herein, the proposed reorganization of UniSource is in the public interest and complies with A.A.C. 14-2-803(C)."

ORDERING PARAGRAPHS

DELETE Page 49, Lines 2 and 3, and INSERT:

‘TT IS THEREFORE ORDERED that the application of UniSource Energy Services for its reorganization is approved subject to the conditions set forth in this Decision.

IT IS FURTHER ORDERED that, consistent with the conditions set forth in our discussion above and Findings of Fact 47, 48 and 49, Kohlberg, Kravis Roberts & Co., L.P., JP Morgan Partners and/or Wachovia Capital Partners will upon closing invest an additional \$50 million in the form of an equity contribution to UniSource, and the source of funds for the equity infusion cannot come from increasing the debt level proposed in the application of \$660 million from Saguaro Holdings and/or Saguaro L.P./Saguaro Utility Corp. Tucson Electric Power Company, UNS Electric and UNS Gas shall, at a minimum, receive at least a \$10 million each from UniSource from the additional \$50 million in equity contributions made by Kohlberg, Kravis Roberts & Co., L.P., JP Morgan Partners and/or Wachovia Capital Partners. UniSource Energy Services shall determine the specific amounts that each utility will receive in equity contributions in excess of the \$10 million per utility requirement until the \$50 million is exhausted. If the \$10 million requirement per utility creates a hardship for UniSource Energy Services or its affiliates, it may petition the Commission to review this condition and the Commission may consider such a request. However, the Commission will not entertain a request to reduce the \$50 million figure as that equity infusion into UniSource Energy Services is necessary to approve this transaction.

IT IS FURTHER ORDERED that in order to maintain and improve the utilities' electricity generation and transmission service quality and ensure that there will not be a deterioration of such services, UNS Electric and Tucson Electric Power Company will continue to adhere to and comply with the Federal Energy Regulatory Commission (“FERC”), North American Reliability Council, (“NERC”) and Western Electricity Coordinating Council (“WECC”) Planning and

Operating Criteria standards and any further requirements adopted by this Commission. The Saguaro Utility Corp., UniSource Energy Services, Tucson Electric Power Company, UNS Electric and UNS Gas will ensure that they will obtain the necessary funds to complete the projects, either for new facilities or the operation and maintenance of facilities that are necessary to maintain compliance with the above mentioned standards. Failure to comply with the conditions set forth in this paragraph may result in Commission action, including but not limited to, monetary sanctions.

IT IS FURTHER ORDERED that in order to maintain and improve the utilities' distribution service quality and to ensure that there will not be a deterioration of such services, a workshop(s) shall be held that specifically addresses Tucson Electric Power Company's, UNS Electric's and UNS Gas' unique circumstances to define how to correctly monitor each of their respective distribution system service quality performance. The workshop(s) shall review criteria that will allow for reasonable justifications for the differences in the character of distribution service quality standards within each of Tucson Electric Power Company's, UNS Electric's and UNS Gas' service territories. The workshop(s) shall address, at a minimum, the type(s) of necessary data to be provided by the utility(s), reporting requirements and schedules, determine service quality performance standards, and establish mechanisms to validate the quality of the data and question the results provided by the utility(s). The workshop(s) shall be conducted on or before June 1, 2005. Staff shall file its recommendation regarding the establishment of service quality performance standards for the utilities to the Commission on or before September 1, 2005. In the interim, UniSource Energy Services, Tucson Electric Power Company, UNS Electric and UNS Gas shall, at a minimum, maintain their current level of service quality, infrastructure improvements and operations and maintenance expenses. Failure to comply with the conditions set forth in this paragraph may result in Commission action, including but not limited to, monetary sanctions.

IT IS FURTHER ORDERED that the lines of credit established by UniSource Energy Services, Tucson Electric Power Company , UNS Electric and UNS Gas shall not be used to fund the purchase or the building of generation assets without Commission approval.

IT IS FURTHER ORDERED that Saguaro Utility Group, L.P. shall be organized as a corporation, rather than as a limited partnership or limited liability company. The new corporate form of Saguaro Utility Group, L.P. shall file proof of its corporate status in this docket within 120 days of the date of this Decision. Any failure to do so will result in conditional approval of this transaction granted herein becoming null and void without further action of the Commission.

IT IS FURTHER ORDERED that the UniSource Energy Services, and its affiliates, shall comply with Findings of Fact Nos. 43 and 44.”

Make all conforming changes

EXHIBIT D

12. Commission Approval of Changes to Management of Saguaro Utility Corp.

Saguaro Utility Corp. will not permit a direct or indirect change in its management without prior Commission approval, except that the shareholders of Saguaro Utility Corp. may, consistent with the terms of its articles and/or bylaws, remove from its corporate management Sage Mountain and replace Sage Mountain without prior Commission approval upon the death or permanent disability of Sage Mountain's controlling member or its controlling member (1) has been convicted of a felony, (2) has committed fraud against Saguaro Utility Corp., (3) of a finding that Sage Mountain's controlling member has acted or omitted to take action on behalf of Saguaro Utility Corp., which act or omission constitute gross negligence or willful misconduct, (4) has breached any material provision of the agreement of limited partnership or any of its fiduciary duties thereunder, (5) is the subject of bankruptcy proceedings or otherwise has sought relief under any bankruptcy or insolvency laws. (6) has liquidated, dissolved or otherwise ceased to be in existence, (7) has suffered a change in control not permitted by the agreement of limited partnership or (8) has failed to comply with applicable laws. Following any such removal and appointment of a new corporate management, Saguaro Utility Corp. will promptly seek Commission approval for permanent management and, if the Commission rejects such permanent management, Saguaro Utility Corp. will undertake to find an alternate replacement management that is reasonably acceptable to the Commission.

13. Commission Approval of Material Changes to Saguaro Utility Corp.

Saguaro Utility Corp. will not permit any change of its shareholder ownership interests without prior Commission approval, except:

- (a) changes which would not result in any new shareholders obtaining in the aggregate more than 10% of all such shareholder interests in Saguaro Utility Corp., or
- (b) changes which result from a transfer by a Saguaro Utility Corp. to any affiliated entity whose investment and management decisions ultimately are made by the same entity or persons which control the existing shareholders of Saguaro Utility Corp.