DIRECT

TESTIMONY

OF

JOEL M. REIKER

JOHN ANTONUK

DOCKET NO. E-04230A-030933

IN THE MATTER OF THE REORGANIZATION OF UNISOURCE ENERGY CORPORATION

APRIL 30, 2004

BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman
WILLIAM A. MUNDELL
Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN MAYES
Commissioner

IN THE MATTER OF THE REORGANIZATION)
OF UNISOURCE ENERGY CORPORATION.)
)

DOCKET NO. E-04230A-03-0933

REDACTED

DIRECT

TESTIMONY

OF

JOEL M. REIKER

SENIOR PUBLIC UTILITIES ANALYST

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

APRIL 30, 2004

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EXECUTIVE SUMMARY

UNISOURCE ENERGY CORPORATION
DOCKET NO. E-04230A-03-0933

The direct testimony of Staff witness Joel M. Reiker addresses the following issue:

The immediate financial impact of UniSource Energy Corporation's ("UniSource") proposed reorganization on its utility subsidiaries.

The proposed reorganization involves the acquisition of UniSource by a private equity partnership known as Saguaro Utility Group L.P. ("Partnership") in a leveraged buyout transaction. The Partnership includes investment funds affiliated with Kohlberg Kravis Roberts & Co., J. P. Morgan Partners, LLC, and Wachovia Capital Partners as Limited partners, and Sage Mountain L.L.C., an Arizona company who's membership interest is currently owned and managed by Frederick B. Rentschler, as general partner.

The Partnership will acquire 100 percent of UniSource's outstanding common stock through its subsidiary Saguaro Utility Group I Corp. ("Saguaro Holdings"). UniSource would then be a wholly-owned subsidiary of Saguaro Holdings, and ultimately, the Partnership.

The acquisition will be financed with a Partnership cash equity contribution of up to $556.7 million, and up to $660 million of debt ("acquisition debt") to be issued by Saguaro Holdings. The debt is expected to be non-investment grade. Of the $1,216.7 million financing package, approximately $880 million will be paid to UniSource's existing stock and option holders, up to $263 million will be paid to Tucson Electric Power ("TEP") in the form of a cash infusion, and the remainder (approximately $74 million) will be used to pay fees and expenses. The financing package will also include a 5-year, $50 million revolving credit facility and a 5-year, $40 million revolving credit facility to be made available to UniSource and UniSource Energy Services ("UES"), respectively.

The capital structures of UES' gas and electric subsidiaries, UNS Gas and UNS Electric, are not expected to change as a result of the proposed transaction. The $263 million cash infusion to TEP, which includes the repayment of a $95 million intercompany note owed to TEP by UniSource and $168 million in cash, will be used to retire long-term debt and issue equity, increasing TEP's equity ratio for ratemaking purposes to 40 percent of capitalization. As a result, a Commission restriction precluding TEP from paying dividends in excess of 75 percent of net earnings until such time as TEP's equity ratio equals 40 percent of capitalization will be lifted. Total consolidated debt will increase by approximately $400 million, from approximately 80.1 percent to 81.3 percent of total capitalization.

Assuming UES' borrowing costs do not increase, the cost of capital to UNS Gas and UNS Electric are not expected to change as a result of the proposed transaction. According to information provided by UniSource, TEP's effective cost of long-term debt, as calculated on November 30, 2003, will decrease 10 basis points as a result of the retiring of debt related to the $263 million cash infusion. To the extent the credit rating agencies, and ultimately the markets, view TEP's credit profile as being affected by the fundamentals of the consolidated entity rather than on a stand-alone basis, Staff believes TEP's credit rating may actually suffer rather than improve, resulting in an increase in TEP's future cost of debt.

Standard financial principles suggest that reducing TEP's debt ratio also reduces its cost of equity. If the transaction does not occur TEP expects to achieve a 40 percent equity ratio in approximately five years. Therefore, assuming the business risk associated with the regulated utility industry does not change, increasing TEP's common equity ratio to 40 percent as a result of the proposed transaction has the same effect on its cost of equity as achieving a 40 percent equity ratio over a period of five years.

Assuming TEP does not experience a rating downgrade, Staff estimates the effect of the proposed transaction on TEP's overall cost of capital to be minimal. Both the cost of debt and equity to TEP are expected to decrease, however, the proportion of equity in the capital structure will increase, and equity is generally thought of as having a higher cost than debt.

The Partnership has agreed to purchase UniSource's common stock for $25.25 per share. This represents approximately a 30 percent premium over the market price per share prior to the announcement of the acquisition. Because the transaction does not involve the union of two firms, such a premium cannot be justified by any possible synergies or economies of scale. The premium paid in a leveraged buyout is typically justified by expected cost reductions and management improvements, which are normally achieved by giving management an equity stake in the business.

The Partnership estimates interest expense payments related to the acquisition debt in the first year after the close of the transaction to be $45 - $60 million. Saguaro Holdings will service the acquisition debt with dividends received from TEP and UES as well as its own cash flows. Saguaro Holdings' own cash flows will result from income tax benefits related to the acquisition debt. The tax benefit occurs because the consolidated entity benefits from the tax deductibility of the interest on the acquisition debt, while the individual subsidiaries do not. According to information provided by the Partnership, Saguaro Holdings' expects to record $20 - $27 million in income tax benefit in 2005.

INTRODUCTION

Q. Please state your name, occupation, and business address.

A. My name is Joel M. Reiker. I am a Public Utilities Analyst V employed by the Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

Q. Briefly describe your responsibilities as a Public Utilities Analyst V.

A. In my capacity as a Public Utilities Analyst V, I provide recommendations to the Commission on mergers, acquisitions, financings and sales of assets. I also perform studies to estimate the cost of capital for utilities that are seeking rate relief, and I have occasionally acted as arbitrator in disputes brought before the Utilities Division.

Q. Please describe your educational background and professional experience.

A. In 1998, I graduated cum laude from Arizona State University, receiving a Bachelor of Science degree in Global Business with a specialization in finance. My course of studies included classes in corporate and international finance, investments, accounting, and economics. I began employment as a Staff rate analyst in 1999. Since that time, I have attended various seminars and classes on general regulatory and business issues, including the cost of capital and the use of energy derivatives. I have participated in over fifty regulatory proceedings.

Purpose of Testimony

Q. What is the purpose of your testimony in this case?

A. The purpose of my testimony is to present Staff's analysis of the immediate financial impact of UniSource Energy Corporation's ("UniSource") proposed reorganization on its utility subsidiaries.

Q. What other Staff witness sponsors testimony and what does he/she address?

A. Mr. John Antonuk of The Liberty Consulting Group will address other reorganizations and acquisitions in the utility industry, additional financial issues, other concerns of Staff, as well as specific questions of the Commissioners. Mr. Antonuk's testimony will present Staff's conclusions and recommendations in this case.

THE PROPOSED REORGANIZATION

Q. Please provide a brief description of the proposed reorganization.

A. The proposed reorganization involves the acquisition of UniSource by a private equity partnership known as Saguaro Utility Group L.P. ("Partnership") in a leveraged buyout transaction (UniSource and the Partnership are collectively referred to as the "Parties".) The Partnership includes investment funds affiliated with Kohlberg Kravis Roberts & Co. ("KKR"), J. P. Morgan Partners, LLC ("J. P. Morgan Partners"), and Wachovia Capital Partners ("Wachovia") as limited partners, and Sage Mountain L.L.C. ("Sage Mountain"), an Arizona company who's membership interest is currently owned and managed by Frederick B. Rentschler, as the general partner.

UniSource Energy Corporation

Q. Please provide a brief description of UniSource.

A. UniSource is the holding company for Tucson Electric Power Company ("TEP"), UniSource Energy Services ("UES"), Millenium Energy Holdings, Inc. ("Millenium"), and UniSource Energy Development Company ("UED"). According to its December 31, 2003 Form 10-K filed with the Securities and Exchange Commission ("SEC"), UniSource had total assets of $3.0 billion for the year ended December 31, 2003, and generated revenues of $970 million and earned net income of $113 million. UniSource's common stock is currently traded on the New York Stock Exchange ("NYSE") under the symbol UNS.

UniSource Energy Corporation's Subsidiaries

Q. Please provide a brief description of UniSource's utility subsidiaries.

A. UniSource's largest operating subsidiary is TEP. TEP generates, transmits, and distributes electricity to over 360,000 customers in the City of Tucson, Arizona, the surrounding Pima County area, and Fort Huachuca in Cochise County. TEP had total assets of $2.7 billion at December 31, 2003, generated annual revenues of $849 million and earned net income of $128 million for the year.

On August 11, 2003, UniSource formed two new operating subsidiaries, UNS Gas, Inc. ("UNS Gas") and UNS Electric, Inc. ("UNS Electric"), to acquire the Arizona gas and electric assets of Citizens Communications Company ("Citizens"). UES was formed as an intermediate holding company to hold the common stock of UNS Gas and UNS Electric. The acquisition added approximately 127,000 retail gas customers and 80,000 retail electric customers in northern and southern Arizona to UniSource's customer base. According to its September 30, 2003 form 10-Q filed with the SEC, UES has assets of $294 million. Revenues and net income for the nine months ending September 30, 2003, were $34.3 million and $135 thousand, respectively.[1]

Q. Please provide a brief description of UniSource's nonregulated subsidiaries.

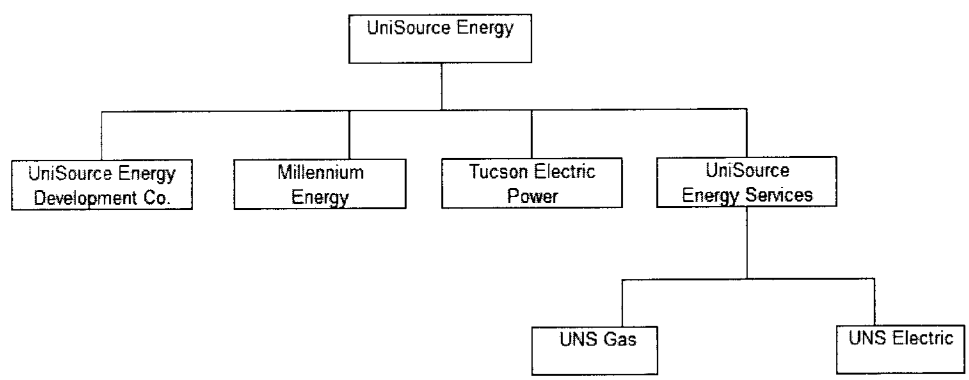
A. UniSource's nonregulated subsidiaries include Millennium and UED. Millennium invests in the development of thin-film batteries, small-scale commercial satellites, and

[1] UniSource reports combined information to the SEC for UNS Gas and UNS Electric under the UES business segment.

photovoltaic cells. UED is involved in the development of generating resources and other nonregulated activities.

The following figure shows the current structure of the UniSource Energy Corporation consolidated entity:

Figure 1



The Partnership

Q. Please provide a brief description of the limited partners.

A. KKR is a private investment firm headquartered in New York, London, and Menlo Park, California. The primary investors in KKR funds are state and corporate pension funds, banks, insurance companies, and university endowments. KKR has been known as a "buyout specialist." In 1989, KKR acquired RJR Nabisco in a $25 billion takeover, the largest leveraged buyout ever.

After the close of the proposed transaction, KKR affiliated funds will own approximately 62 percent of the equity in the surviving entity.

J. P. Morgan Partners is an indirect wholly-owned subsidiary of J. P. Morgan Chase & Co., one of the largest financial institutions in the United States. J. P. Morgan Partners has approximately $19 billion in assets under management. After the close of the proposed transaction, J. P. Morgan Partners will own approximately 31 percent of the equity in the surviving entity.

Wachovia is the principal investing group of Wachovia Corporation, the nation's fifth-largest bank holding company. After the close of the proposed transaction, Wachovia will own approximately 7 percent of the equity in the surviving entity.

Q. Please provide a brief description of the general partner.

A. Sage Mountain is an Arizona Limited Liability Company who's membership interest is currently owned and managed by Frederick B. Rentschler, an Arizona resident. According to the Parties' response to Staff data request JMR 2-42 (Exhibit JMR-1), Mr. Rentschler currently serves on the boards of International Game Technology, Grocery Outlets Inc., the Salk Institute for Biological Studies, Vanderbilt University, and Scottsdale Healthcare. Mr. Rentschler has fifteen years of experience as president and CEO of, among others, Armour Dial, Beatrice Companies, and Northwest Airlines.

Purpose of the Proposed Reorganization

Q. Why has UniSource entered into the acquisition agreement?

A. According to the Notice of Intent filed with the Commission on December 30, 2003, UniSource entered into the agreement to strengthen the financial condition of TEP and produce benefits to customers, employees, and local communities:

> UniSource Energy entered into the Merger Agreement because it will materially strengthen the financial condition of TEP and thereby produce substantial benefits to UniSource Energy's customers and employees, as well as the local communities served by UniSource Energy. The financial strength and other resources of the investors will position UniSource Energy to have access to

> adequate capital for the service needs of its customers. The merger also will allow current UniSource Shareholders to realize fair value for their investment. In addition, [the Partners] believe that they are making a sound long-term investment in UniSource Energy, whose affiliated public utilities have substantial opportunities to grow and improve their respective services.

According to its Proxy Statement filed with the SEC on February 2, 2004, UniSource entered into the agreement because the transaction is in the best interests of the Company and its shareholders:

> We entered into the acquisition agreement because our board of directors believes, after careful consideration, that the acquisition and the acquisition agreement are advisable and fair to, and in the best interests of, our company and our shareholders since, among other reasons, the acquisition consideration represents a significant premium over the historical trading price of our common stock. The $25.25 cash acquisition consideration represents a 30% premium over the closing price per share on the last trading day prior to the public announcement of the acquisition.

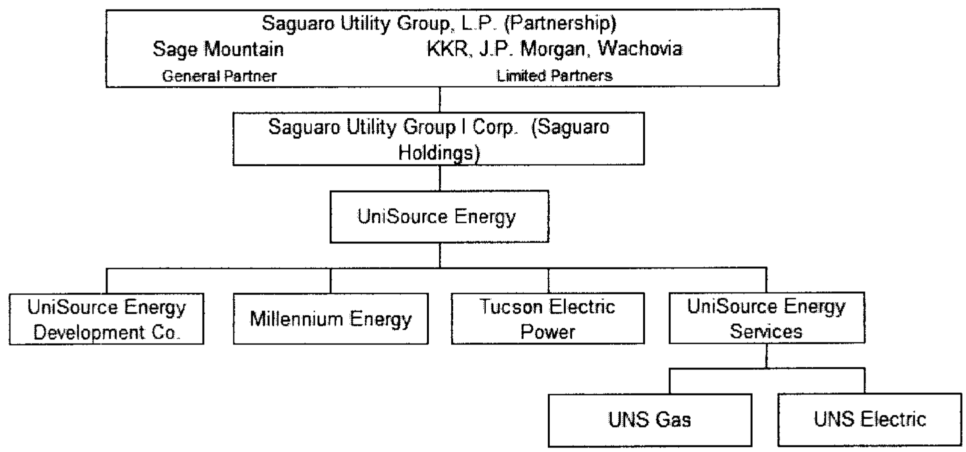
Mechanics of the Proposed Reorganization

Q. How will UniSource be acquired?

A. The Partnership will acquire 100 percent of UniSource's outstanding common stock through its subsidiary Saguaro Utility Group I Corp. ("Saguaro Holdings"). The acquisition will be accomplished through the merger of Saguaro Acquisition Corp. ("Saguaro Acquisition"), a direct subsidiary of Saguaro Holdings, and UniSource, with UniSource being the surviving entity. UniSource will then be a wholly-owned subsidiary of Saguaro Holdings.

The following figure shows the proposed structure of the consolidated entity after the reorganization:

Figure 2



Q. **How will the acquisition be financed?**

A. The Partnership will provide Saguaro Holdings with a cash equity contribution of up to $556.7 million. In addition, Saguaro Holdings will borrow up to $360 million in the form of senior secured bank loans [redacted][2] and issue up to $300 million in senior unsecured notes (collectively referred to as the "acquisition debt"). The proceeds of the $1,216.7 million financing package will be used as follows: Approximately $880 million will be paid to UniSource's existing stock and option holders, up to $263 million will be paid to TEP in the form of a cash infusion, and the remainder (approximately $74 million) will be used to pay fees and expenses related to the acquisition. The following table shows how the acquisition will be financed:

[2] Please note that this testimony contains information that the Parties have classified "Confidential" under the terms of a Protective Agreement that UniSource and Staff entered into and docketed on January 22, 2004. Such currently considered "Confidential" information has been redacted (i.e. blacked out) in the docketed version of this testimony and appears in the unredacted version in italics.

Table 1

Sources of funds	**In millions**
Equity contribution by Partnership	$556.7
Senior secured bank loans	$360.0
Unsecured notes	$300.0
Total	$1216.7
Uses of funds	
Purchase of UniSource common stock & options	$880
Cash infusion to TEP	$263
Fees and expenses	$73.7
Total	$1216.7

Q. Will the financing package include a credit facility?

A. Yes. In addition to the above financing package, a 5-year $50 million revolving credit facility will be made available to UniSource, and a 5-year $40 million revolving credit facility will be made available to UES. The credit facilities will be made available through Saguaro Holdings.

Q. Will UniSource incur any debt in connection with the proposed reorganization?

A. No. The acquisition debt will be issued by Saguaro Holdings.

Q. Is the acquisition debt expected to be investment grade?

A. No. According to the Parties' response to Staff data request JMR 2-44 (Exhibit JMR-2), the acquisition debt is expected to be non-investment grade. Bonds rated Ba/BB[3] and below, are "high yield" and considered to be non-investment grade due to their high risk of default relative to investment grade bonds. (See Exhibit JMR-3)

[3] Ba: Moody's. BB: Standard & Poor's.

Q. Will UniSource's stock continue to be publicly traded after the close of the proposed reorganization?

A. No. UniSource's common stock will be privately held by Saguaro Holdings and ultimately, the Partnership.

Q. Will the Partnership and Saguaro Holdings qualify as Public Utility Holding Companies as defined in Arizona Administrative Code R14-1-801?

A. Yes. The Partnership and Saguaro Holdings will both qualify as Public Utility Holding Companies as defined in Arizona Administrative Code R14-1-801.

Q. Who will serve on the boards of directors of Saguaro Holdings and UniSource after the close of the proposed reorganization?

A. Mr. Rentschler is the sole director of Saguaro Holdings. UniSource's board of directors will consist of Mr. Rentschler and Mr. James Pignatelli, UniSource's current Chairman, President and CEO. The Partnership has no board of directors.

Q. Why does Staff characterize the proposed reorganization as a leveraged buyout?

A. Leveraged buyouts are characterized by four distinctive features: A large fraction of the purchase price is financed with debt. A large portion, if not all, of the debt is below investment-grade. The acquired entity goes private and its shares are no longer traded on the open market. And the stock of the acquired entity is held by a partnership of investors. The proposed reorganization has all of these features.

Q. Does the Partnership have a term?

A. Yes. The term of the partnership is 25 years. However, the term of the partnership is not necessarily indicative of the Partnership's investment horizon. Staff inquired as to the Partnership's investment horizon and the Parties responded as follows:

> Saguaro Utility Group L.P. has established no "investment horizon" for its UniSource investment. It certainly regards it as a multi-year, long-term investment, but the specific duration would depend on a wide variety of both future operational and market developments which cannot at this time be forecast with any certainty. However, it should be noted that KKR's average holding period for investments is in excess of seven years and [J.P. Morgan Partners'] average holding period is longer than six years. (See Exhibit JMR-4)

According to a March 11, 2004 report by Standard & Poor's, the Partnership has indicated that its intended investment horizon for UniSource is six to eight years. (see Exhibit JMR-14)

ANALYSIS

Capital Structure

Q. What effect will the proposed reorganization have on the capital structures of UniSource's regulated utility subsidiaries?

A. The capital structures of UNS Gas and UNS Electric are not expected to change as a result of the proposed reorganization. According to the Parties' response to Staff data request JMR 4-78 (See Exhibit JMR-5), as of December 31, 2003, UNS Gas' capital structure consisted of approximately 65 percent debt and 35 percent equity and UNS Electric's capital structure consisted of approximately 64 percent debt/capital lease obligations and 36 percent equity.

The $263 million cash infusion to TEP, which includes the repayment of a $95 million intercompany note owed to TEP by UniSource and $168 million in cash, will be used to retire long-term debt and issue equity. TEP's current capital structure[4] consists of approximately 75 percent debt and 25 percent equity. After the close of the proposed reorganization, TEP's capital structure will consist of approximately 60 percent debt and 40 percent equity.

Q. Does this change in TEP's capital structure as proposed in the reorganization represent an improvement?

A. Yes. The proposed change in TEP's capital structure as proposed in the reorganization represents an improvement on a stand-alone basis. Increasing TEP's equity ratio satisfies the Commission's goal, as set forth in Decision Nos. 60480[5] and 66028, that TEP achieve an equity ratio of at least 40 percent of ratemaking capitalization. According to the Parties, achievement of a 40 percent common equity ratio will be accelerated by at least five years as a result of the proposed reorganization. A consequence of this change will be the lifting of a restriction set forth in the above decisions which precludes TEP from paying dividends in excess of 75 percent of net earnings until such time as TEP's equity ratio equals 40 percent of ratemaking capitalization. Staff discusses the effect of lifting TEP's dividend restriction later in its testimony.

Q. Does TEP's ratemaking capitalization understate its true degree of financial leverage?

A. Yes. As of December 31, 2003, TEP had approximately $760 million in capital lease obligations which the Commission has excluded from capitalization for ratemaking purposes. Thus, TEP's true capital structure consists of approximately 83 percent debt and 17 percent equity. After the close of the proposed reorganization TEP's true capital

[4] The Commission has excluded capital lease obligations for ratemaking purposes. TEP's current capital structure is approximately 83 percent debt and 17 percent equity including capital lease obligations.
[5] The Commission's original goal set forth in Decision No. 60480 was an equity ratio of 37.5 percent.

structure will consist of approximately 74 percent debt and 26 percent equity. (See Exhibit JMR-6)

Q. What immediate effect would the proposed reorganization have on the capital structure of the consolidated entity?

A. The proposed reorganization would slightly increase the consolidated entity's leverage. The September 30, 2003, pro forma consolidated balance of long-term debt (including capital lease obligations) would increase by approximately $400 million, from 80.1 percent to 81.3 percent of total capitalization. (See Exhibit JMR-7 and Exhibit JMR-8)

Q. Does Saguaro Holdings expect to de-leverage itself after the reorganization?

A. Yes. [redacted]

Q. Is the repayment of debt a typical use of excess cash flow after a leveraged buyout?

A. Yes. Excess cash flow is typically devoted to the repayment of debt as quickly as possible after a leveraged buyout.

The Cost of Capital

Q. What effect would the proposed reorganization have on the cost of capital to UniSource's utility subsidiaries?

A. UNS Gas' and UNS Electric's capital structures and business profiles are not expected to change as a result of the proposed reorganization. Therefore, other things equal, the cost of capital to UNS Gas and UNS Electric are not expected to change.

However, as Staff discusses below, at least one credit rating agency is concerned that the additional debt burden associated with the proposed reorganization will further erode the credit quality of TEP. UNS Gas' and UNS Electric's notes are rated by the National Association of Insurance Commissioners ("NAIC"), and are considered high quality and medium quality, respectively.[6] While those ratings have not changed, to the extent the additional burden associated with the acquisition debt affects the credit quality of UNS Gas and UNS Electric, their future cost of borrowing may increase.

Q. What effect would the proposed reorganization have on TEP's cost of debt?

TEP's ratemaking capital structure is expected to improve to 60 percent debt and 40 percent equity. In response to Staff data request JMR 1-9 (See Exhibit JMR-9), the Parties indicate that TEP's effective cost of long-term debt as of November 30, 2003, will decrease 10 basis points, from 6.88 percent to 6.78 percent, as a result of the proposed reorganization. This represents a reduction in annual interest expense of approximately $18 million.

To the extent the credit rating agencies, and ultimately the markets, view TEP's credit profile as being affected by the fundamentals of the consolidated entity rather than on a stand-alone basis, Staff believes that TEP's credit rating may actually suffer rather than improve, resulting in an increase in TEP's future cost of borrowing.

Q. How have the credit rating agencies reacted to the proposed reorganization?

A. TEP's credit is rated by Fitch Ratings ("Fitch"), Moody's Investors Service ("Moody's"), and Standard & Poor's ("S&P".)[7] After the announcement of the proposed transaction,

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[5] UNS Gas' notes are rated NAIC-2 (high quality). UNS Electric's notes are rated NAIC-3 (medium quality).
[7] See Exhibit JMR-10 for TEP's current bond/credit ratings.

Fitch and Moody's confirmed their current ratings and maintained a "stable" outlook for TEP. However, S&P placed TEP on "CreditWatch" with negative implications.

According to a press release issued on December 1, 2003, Fitch affirmed TEP's secured debt ratings at BB+ with a rating outlook of "stable:"

> Concern regarding TEP's status as a subsidiary of a highly leveraged parent company, is mitigated by the pre-funded debt redemption feature of the merger proposal and regulatory provisions limiting dividends to 100% of the utility's net income.[8] (See Exhibit JMR-11)

On November 25, 2003, Moody's also confirmed its ratings of TEP and maintained a stable outlook:

> The rating confirmation reflects the fact that TEP's standalone credit profile will likely remain unchanged following the acquisition...
>
> ...the rating action also considers the fact that consolidated debt will increase by $400 million upon completion of the transaction and that any free TEP cash flow will be required to service a sizeable amount of holding company debt and to provide some level of return to the new owners. Moody's views the dividends necessary to service the $660 million of holding company debt and to provide a return to the owners as being less discretionary in nature from management's perspective. (See Exhibit JMR-12)

The November 24, 2003 press release by S&P, was relatively negative:

> Standard & Poor's prior stable outlook on TEP was based on the expectation that UniSource would continue to work toward reducing its overall debt burden. Now, however, TEP's ratings may be lowered in the near-term, after a thorough review of the details of the transaction, because of UniSource's unexpected move toward a leveraged buyout structure, which, regardless of

[8] Section 305(a) of the Federal Power Act states that dividends shall not be paid out of funds properly included in the capital account. Fitch characterized this provision of the Federal Power Act as limiting dividends to a utility's net income.

> whether the transaction is completed or not, raises concerns about management's commitment to credit quality...
>
> ...Standard & Poor's is concerned that the additional debt burden as proposed under the transaction will further erode credit quality. (See Exhibit JMR-13)

In a March 11, 2004 Q&A, S&P addressed the factors it will consider in deciding whether to downgrade TEP:

> Management's decision to increase debt levels as part of the acquisition strategy will be considered against several possible mitigating factors:
>
> - Annual free cash flows at TEP after capital expenditures are projected remain strong at least $100 million over the next four years;
> - The transaction will reduce the utility's exposure to variable rate debt by one-half to about 15%; and
> - The transaction may lower TEP's regulatory risk in future rate reviews, the first of which will occur in 2004 when TEP is expected to file a transmission and distribution general rate case. (See Exhibit JMR-14)

The announcement and action by S&P indicates that that rating agency views the credit profile of UniSource's utility subsidiaries as being affected by the qualitative and quantitative fundamentals of the consolidated entity, rather than the individual subsidiary alone.

Q. Have the Parties offered to agree to any conditions in connection with approval of the proposed reorganization that they assert provide protection to ratepayers from a downgrade in TEP's bonds?

A. Yes. According to the direct testimony of Mr. Pignatelli, the Parties will not seek to recover an increase in the cost of interest on bonds which are downgraded in connection with the reorganization:

> I will commit that in the event that TEP's bonds are downgraded in connection with the Merger, TEP will not seek to recover the cost of interest on those bonds greater than the cost of interest on bonds rated the same as TEP's bonds prior to the downgrade. So, even if TEP's bonds are downgraded, in connection with the Merger, there will not be a related raise in rates. (See the direct testimony of James S. Pignatelli, p. 6 at 4 – 8)

Q. Does this commitment, as stated, represent anything beyond what is normal ratemaking procedure?

A. No. Normal ratemaking allows a public utility to recover its "embedded" cost of debt – that is, total interest payments divided by the book value of outstanding debt. The utility's current borrowing rate, as indicated by a bond rating, can be, and often is, higher or lower than its embedded cost of debt. For example, assume a utility issues $10,000 in Baa-rated bonds at 5.0 percent. After paying issuance expenses and other costs associated with the bonds, the utility receives $9,500 in net proceeds. The utility pays annual interest expense of $500 (5.0% x $10,000.) The utility's effective cost of debt that is recovered through rates is 5.3 percent ($500 ÷ $9,500.) While downgrading the utility's bond rating may reflect a decline in the market value of the utility's outstanding bonds and the interest rate on any future borrowing, it does not change the utility's effective cost of debt that is recovered through rates. In other words, changes in the market value of existing debt do not affect the cost of that debt included in the cost of service recovered through rates.

Accordingly, Staff does not view the Company's commitment as providing ratepayers protection from a potential increase in the cost of service due to the Company issuing *new* debt or *refinancing* existing debt at a higher rate, after a rating downgrade.

Q. What effect will the proposed reorganization have on TEP's cost of equity and overall cost of capital?

A. Standard financial principles suggest that as a firm decreases leverage, its cost of equity goes down. Therefore, TEP's cost of equity would decrease, *other things equal.*

The cost of equity to any firm is a function of the risk-free rate of interest and the premium investors require for investing in the market, adjusted for the market risk of the firm. Market risk is commonly measured by the capital asset pricing model beta. The higher the beta, the higher the risk of the company's stock, and other things equal, the higher its cost of equity. According to *The Value Line Investment Survey*, the average debt ratio and beta for comparable publicly-traded electric utilities is .56 and .67, respectively. A mathematical equation used to estimate the effect leverage has on a stock's beta indicates that decreasing TEP's debt ratio from .75 to .60 decreases its beta from .86 to .69. This is an estimate of the reduction in the riskiness of TEP's common equity as a result of the $263 million cash infusion.

Using a hypothetical example, it can be shown that decreasing a company's beta from .86 to .69 reduces its cost of equity. Assume investors require a return of 3.5 percent for investing in a risk-free asset, which is usually represented by a U.S. Treasury security, and they require an additional 7.5 percent for investing in an average-risk security, such as a share of the S&P 500. A hypothetical company with a beta of .86 would have a cost of equity of 9.95 percent (3.5% + [.86 x 7.5%].) If the hypothetical company's beta subsequently decreased to .69, its cost of equity would decrease to 8.68 percent (3.5% + [.69 x 7.5%]), *other things equal.*

Assuming the business risk associated with the regulated electric utility industry remains constant, increasing TEP's common equity ratio to 40 percent of capitalization with one $263 million cash infusion today has the same effect on its cost of equity as achieving a 40 percent equity ratio over a period of five years (which TEP expects to do if the reorganization does not occur.)

Assuming TEP does not experience a rating downgrade, Staff estimates the effect of the proposed transaction on TEP's overall cost of capital to be minimal. Both the cost of debt and equity to TEP are expected to decrease, however, the proportion of equity in the capital structure will increase, and equity is generally thought of as having a higher cost than debt.

It should also be noted that TEP's current rates were based on a hypothetical capital structure consisting of 62.5 percent debt and 37.5 percent equity.[9] Therefore, any change in TEP's overall authorized rate of return granted in a rate proceeding would likely be unrelated to its capital structure.

The Premium and its Effects

Q. What is the amount of the premium that the Partnership expects to pay for UniSource?

A. The Partnership has agreed to purchase UniSource's common stock for $25.25 per share. The $25.25 price per share represents approximately a 30 percent premium over the

[9] Decision No. 59594, dated March 29, 1996.

closing price per share on the NYSE prior to the merger announcement. UniSource shareholders are being offered $25.25 per share for their stock that had been valued by the market at $19.40 per share[10] before the merger announcement. The gain per share is $5.85 on approximately 33.7 million shares of UniSource stock outstanding (according to the February 13, 2004 edition of *The Value Line Investment Survey*) for a total premium of approximately $197 million.

Q. How does the Partnership expect to earn back such a premium on its UniSource investment?

A. According to the Parties' response to Staff data request JMR 1-23 (See Exhibit JMR-15), the Partnership believes it will earn back the premium the following ways:

> Saguaro LP/Saguaro Holdings believe the premium reflected in their acquisition price is justified by a number of factors and will be returned over time based on these primary strengths of the UniSource utility subsidiaries: (1) solid company management, (2) sound regulatory and community relationships, (3) service territory growth, (4) existing low cost generating resources and (5) sufficient internally generated funds to meet projected capital and debt service expenditures.

Q. Can such a premium be justified by any possible synergies or economies of scale?

A. No. The proposed transaction does not involve the union of two firms, so there can be no synergies or economies that cannot otherwise occur absent the proposed transaction. While the expected tax savings created by the tax deductibility of the interest on the acquisition debt provide future cash flow benefits, it alone does not justify the premium paid. The premium paid in a leveraged buyout is typically justified by expected cost reductions and management improvements.

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[10] Closing price per share on November 21, 2003, according to Yahoo Finance.

Q. How are cost savings and management improvements normally achieved after a leveraged buyout?

A. Cost savings and management improvements are achieved by giving management an equity stake in the business. This provides a strong incentive to cut costs and improve operating profits, thereby increasing the value of the firm.

Q. Did Staff inquire as to whether management expects to have an equity stake in the post-acquisition entity?

A. Yes. According to the Parties' response to Staff data request JMR 3-57 (See Exhibit JMR-16):

> …the Company expects to offer officers an opportunity to have an equity interest in the post-acquisition entity. However, no officer has entered into any agreement, arrangement or understanding regarding the right to purchase or participate in the equity of the post-acquisition entity.

According to UniSource's Joint Application for authorization under Section 203 of the Federal Power Act for Disposition of Jurisdictional Facilities, filed on April 15th, 2004:

> At or after the closing of the Transaction, management and employees of UniSource Energy may be given an opportunity to invest, or awarded options to acquire stock, in Saguaro Utility Group I Corp…[11]

Q. Have the Parties identified any costs that they believe can be reduced?

A. According to the Parties' response to Staff data request JMR 4-87 (See Exhibit JMR-17), TEP expects to reduce interest costs through continued de-leveraging. The amount of savings will depend on the amount of cash available and the specifics of each debt retirement or lease debt purchase. The Parties assert that there will be no cutbacks in

[11] Page 5.

capital expenditures and no layoffs or reductions in workforce after the close of the proposed transaction. The Parties have not identified any specific operating costs that they believe can be reduced regardless of whether the proposed transaction occurs.

Q. Did Staff review UniSource's preliminary financial forecasts during the course of its investigation?

A. Yes. Staff reviewed UniSource's preliminary financial forecasts assuming the reorganization occurs. [redacted]

[redacted]

Q. Are there ways for investors to earn excess returns that do not necessarily involve cost-cutting?

A. Yes. An investor can earn an excess return (a return greater than the return she requires) through a form of financial pyramiding that occurs when a parent company issues debt to finance its equity investment in a subsidiary. This is known as "double-leverage."

Q. **How do investors earn excess returns through double-leverage?**

A. When debt is issued by both the utility and the holding company, and the utility is allowed to earn a return on its equity capital equal to its market cost of equity, it is possible for the investors in the holding company to earn a return on their equity investment that is *greater* than their cost of equity. This can be illustrated by using a simplified example. Table 2 shows the weighted average cost of capital ("WACC") to a hypothetical operating subsidiary and its parent:

Table 2

Operating Subsidiary

	Amount	Weight	Cost	Weighted Cost
Debt	$60	60%	6.0%	3.60%
Equity	40	40%	9.0%	3.60%
	100		WACC	7.20%

Parent Holding Company

	Amount	Weight	Cost	Weighted Cost
Debt	$24	60%	6.0%	3.60%
Equity	16	40%	9.0%	3.60%
	40		WACC	7.20%

The subsidiary's capital structure consists of 60 percent debt and 40 percent equity, with accompanying costs of 6 percent and 9 percent, respectively. The parent has invested $40 in the subsidiary, which is also financed with 60 percent debt and 40 percent equity, whose accompanying costs are also 6.0 percent and 9.0 percent, respectively. In the example, the parent earns $3.60 on its $40 equity investment in the subsidiary (9% x $40 = $3.60.) However, after the parent pays the interest expense associated with its own debt of $1.44 ($24 x 6.0% = $1.44), the parent's shareholders receive $2.16 ($3.60 - $1.44 = $2.16.) This $2.16 in earnings represents a 13.5 percent return on an equity investment of $16 ($2.16 ÷ $16 = 13.5%). In the example shown in Table 2, the parent's shareholders earn a 13.5 percent return on an investment in which they only require a 9 percent return.

Q. Will Saguaro Holdings issue debt to finance its equity investment in UniSource?

A. Yes. The acquisition debt will be used to purchase UniSource's common stock.

Q. Have investment professionals commented on the return the Partnership is expected to earn?

A. Yes. According to a February 2004 article in *Public Utilities Fortnightly*, an analysis conducted by an anonymous Wall Street investment banker using public data suggests a cash on cash return on the Partnership's equity investment of 18.6 percent.[12]

Q. Did Staff conduct an analysis of the expected return on the Partnership's investment?

A. Yes. [redacted]

The Acquisition Debt

Q. What is the annual interest obligation associated with the acquisition debt?

A. Although the precise terms of the acquisition debt have not been established, Staff estimates annual interest expense associated with the acquisition debt to be in the range of $40 - $50 million. According to a response to a Residential Utility Consumer Office

[12] See Stavros, Richard. "Taking Utilities Private: Return of the Barbarians." *Public Utilities Fortnightly*. February 2004. pp. 24 – 29.

[13] [redacted]

("RUCO") data request, the Parties estimate interest expense payments related to the acquisition debt in the first year after the proposed reorganization to be $45 - $60 million. (See Exhibit JMR-18)

Q. How will Saguaro Holdings service the acquisition debt?

A. Saguaro Holdings will use dividends received from TEP and UES as well as its own cash flows to service the acquisition debt. As mentioned previously, the $263 million cash infusion to TEP will result in the lifting of a restriction which precludes TEP from paying dividends in excess of 75 percent of its net earnings. Therefore, TEP will be able to payout 100 percent of its earnings as dividends to UniSource, and ultimately Saguaro Holdings, after the proposed reorganization. UNS Gas and UNS Electric currently operate under a similar condition set forth in Decision No. 66028, which precludes them from paying dividends greater than 75 percent of net earnings until such time as their equity ratios equal 40 percent of capitalization. As stated previously, UNS Gas' and UNS Electric's equity ratios are currently 35 percent and 36 percent, respectively. Therefore, UNS Gas and UNS Electric are precluded from paying dividends in excess of 75 percent of their net earnings.

Another source of cash available to service the additional debt associated with a leveraged buyout may come from selling off nonessential assets. Staff inquired as to the Parties' plans to sell off or otherwise divest any assets and the Parties responded as follows (See Exhibit JMR-19):

> The Investors have no current plans to sell or divest any of the assets, subsidiaries or investments of UniSource. The merger will not affect any current plans of UniSource Energy to sell or divest any of the assets, subsidiaries or investments of UniSource Energy in the normal course of business.

Q. Did Staff inquire as to the dividends TEP, UNS Gas, and UNS Electric expect to pay after the close of the proposed reorganization?

A. Yes. Staff inquired as to the expected dividend payout ratios of TEP, UNS Gas, and UNS Electric. The Parties provided the following table:

Table 3

	[redacted]					
	[redacted]		[redacted]		[redacted]	
[redacted]	[redacted]		[redacted]		[redacted]	
[redacted]	[redacted]		[redacted]		[redacted]	
[redacted]	[redacted]		[redacted]		[redacted]	
[redacted]	[redacted]		[redacted]		[redacted]	
[redacted]	[redacted]		[redacted]		[redacted]	
[redacted]	[redacted]		[redacted]		[redacted]	

Q. Will Saguaro Holdings have additional sources of cash flow available to service and retire the acquisition debt?

A. Yes. Saguaro Holdings will have an additional source of cash flow in the form of an income tax benefit related to the acquisition debt. UniSource currently has a tax sharing agreement under which each subsidiary computes its taxes on a separate company basis. UniSource receives these payments and pays income taxes to the IRS on a consolidated basis. The difference between the income tax payments received by Saguaro Holdings from its operating subsidiaries and its consolidated income tax payment to the IRS will be additional cash flow to Saguaro Holdings in the form of a tax benefit. The tax benefit occurs because the consolidated entity benefits from the tax deductibility of the interest on the acquisition debt, while the individual subsidiaries do not. According to the Parties' response to a RUCO data request, Saguaro Holdings expects to record \$20 - \$27 million in income tax benefit in 2005. (see Exhibit JMR-20)

Q. What would happen in the event Saguaro Holdings defaulted on the acquisition debt?

A. Part of the acquisition debt (up to $360 million) is expected to be in the form of senior secured term loans [redacted] The remainder of the acquisition debt (up to $300 million) is expected to be in the form of senior unsecured notes backed by Saguaro Holding's general credit and not any specific property. Therefore, the senior unsecured note holders would only have a general claim to Saguaro Holdings' assets in the event of default.

Q. Will Saguaro Holdings pay dividends to the Partnership?

A. According to the Parties' response to a RUCO data request, 100 percent of the remaining cash after interest expense and tax payments will be used for prepayment of the acquisition debt in the first year after the reorganization. (See Exhibit JMR-18) According to its credit agreement, Saguaro Holdings' is required to make annual prepayments on its term loans in an amount equal to a percentage of Excess Cash Flow. The percentage of Excess Cash Flow required to be used as prepayments starts at 100 percent, drops to 75 percent once Saguaro Holdings' consolidated leverage ratio reaches 4-to-1, and drops to 50 percent once the leverage ratio reaches 3.5-to-1.[14] [redacted]

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[14] Excess Cash Flow is defined in the credit agreement as (a) the sum of (1) dividends paid to Saguaro Holdings by its subsidiaries and (2) tax sharing payments received by Saguaro Holdings, less (b) the sum of (1) taxes, (2) interest payments, (3) principal payments and prepayments (other than of the loans under the credit agreement), (4) capital expenditures and other expenditures, (5) payments made in connection with prepayments of debt and (6) certain investments, in each case as paid in cash by Saguaro Holdings on a non-consolidated basis. Leverage Ratio is defined in the credit agreement as the ratio of consolidated total indebtedness to consolidated earnings before interest, taxes, depreciation, and amortization (EBITDA).

[redacted]

CONCLUSION

Q. Are you presenting any specific recommendations in this case?

A. No. The purpose of my testimony is to provide a financial analysis and not to present Staff's recommendations in this case. Staff witness Mr. Antonuk's testimony will present Staff's conclusions and recommendations in this case.

Q. Does this conclude your direct testimony?

A. Yes.

UniSource Energy Corporation's
Responses To Staff's 2nd Set Of Data Requests
Docket No. E-04230A-03-0933
February 9, 2004

JMR 2-42: Please provide a summary of the general partner's experience in: 1) the general field of public utilities and 2) the specific field of electric utilities.

RESPONSE: Frederick B. Rentschler, the managing member of the general partner, has no direct managerial experience in the field of public utilities or specifically electric utilities; upon consummation of the acquisition, however, Mr. Rentschler's role will not be managerial, but rather service on the UniSource Energy Board of Directors. In that regard, he currently serves on the boards of International Game Technology, Grocery Outlets Inc., the Salk Institute for Biological Studies, Vanderbilt University and Scottsdale Healthcare. In addition, Mr. Rentschler's 15 years of experience as president and CEO of, among others, Armour Dial, Beatrice Companies (which was taken private in circumstances similar to those involved here) and Northwest Airlines, has given him extensive experience in the types of financial and operational policy matters which he will address in his role as a director of UniSource Energy. Finally, Mr. Rentschler is familiar with regulatory issues, processes and requirements because several of the companies with which he has been involved are subject to state and/or federal regulation.

RESPONDENT: Frederick B. Rentschler
President, Saguaro Utility Group I Corp.
c/o Plattner, Schneidman & Schneider, P.C.
4201 N. 24th St.
Suite 100
Phoenix, AZ 85016

UniSource Energy Corporation's
Responses To Staff's 2nd Set Of Data Requests
Docket No. E-04230A-03-0933
February 9, 2004

JMR 2-44: Is the acquisition debt to be issued by Saguaro Utility Group I Corp. expected to be high yield or investment grade?

RESPONSE: In connection with the closing of the acquisition, Saguaro Utility Group I Corp. is expected to borrow up to $660 million. At this time, the precise terms of this borrowing have not been established, as it will not occur unless and until the ACC approves the acquisition. It is expected, however, that the senior term loans and debt securities involved in the borrowing will be non-investment grade.

RESPONDENT: Frederick B. Rentschler
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Phoenix, AZ 85016

Key to Moody's and Standard & Poor's Bond Ratings

MOODY'S	STANDARD & POOR'S	
Aaa	AAA	Investment grade
Aa	AA	Investment grade
A	A	Investment grade
Baa	BBB	Investment grade
Ba	BB	Non-Investment grade
B	B	Non-Investment grade
Caa	CCC	Non-Investment grade
Ca	CC	Non-Investment grade
C	C	Non-Investment grade

Source: Brealey & Myers. 2000. p. 691.

UniSource Energy Corporation's
Responses To Staff's 4th Set Of Data Requests
Docket No. E-04230A-03-0933
March 5, 2004

JMR 4-80: What is Saguaro LP's investment horizon, in terms of years, for its UniSource investment?

RESPONSE: Saguaro Utility Group L.P. has established no "investment horizon" for its UniSource investment. It certainly regards it as a multi-year, long-term investment, but the specific duration would depend on a wide variety of both future operational and market developments which cannot at this time be forecast with any certainty. However, it should be noted that KKR's average holding period for investments is in excess of seven years and JPMP's average holding period is longer than six years.

RESPONDENT: Frederick B. Rentschler
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4201 N. 24th St.
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UniSource Energy Corporation's
Responses To Staff's 4th Set Of Data Requests
Docket No. E-04230A-03-0933
March 5, 2004

JMR 4-78: Please provide the most recent capital structures of UNS Gas and UNS Electric.

RESPONSE: UNS Gas and UNS Electric were capitalized as follows as of December 31, 2003 (in $000s):

UNS Gas		
Common Equity	$ 52,927	35% of Total
Long-Term Debt	100,000	65% of Total
Total Capitalization	$152,927	

UNS Electric		
Common Equity	$ 34,505	36% of Total
Long-Term Debt	60,000	63% of Total
Capital Lease Obligation	606	1% of Total
Total Capitalization	$ 95,111	

RESPONDENT: Kentton Grant
One South Church Avenue
Tucson, Arizona 85701

TEP's Ratemaking Capital Structure

	12/31/2003		Pro Forma	
Total Long-term Debt	1,126,320	74%	863,320	60%
Common Equity	389,237	26%	582,237	40%
Total Capitalization	1,515,557	26%	1,445,557	100%

TEP's True Capital Structure

	12/31/2003		Pro Forma	
Total Long-Term Debt	1,126,320		863,320	
Total Long-term Capital Lease	762,323		762,323	
Total L-t Debt and Capital Lease	1,888,643	83%	1,625,643	74%
Common Equity	389,237	17%	582,237	26%
Total Capitalization	2,277,880	100%	2,207,880	100%

Consolidated Pro Forma Capitalization
Response to JMR 2-46

($000s)	UniSource Energy Capitalization as of 9/30/2003	Pro Forma Adjustments to Reflect Merger	Saguaro Holdings Pro Forma Capitalization
Long-Term Debt Obligations			
Tucson Electric Power	$ 1,126,685	$ (262,600)	$ 864,085
UNS Gas	100,000	-	100,000
UNS Electric	60,000	-	60,000
Saguaro Holdings Term Loan	-	360,000	360,000
Saguaro Holdings Senior Notes	-	300,000	300,000
Total Long-Term Debt	$ 1,286,685	$ 397,400	$ 1,684,085
Long-Term Capital Lease Obligations			
Tucson Electric Power	$ 761,805	$ -	$ 761,805
Millennium Energy Holdings	50	-	50
Total Long-Term Capital Lease Oblig	$ 761,855	$ -	$ 761,855
Common Stock Equity	$ 508,078	$ 54,622	$ 562,700
Total Capitalization	$ 2,556,618	$ 452,022	$ 3,008,640

	UniSource Energy Capitalization as of 09/30/2003	%	Saguaro Holdings Pro Forma Capitalization	%
Total Long-Term Debt	1,286,685		1,684,085	
Total L-T Capital Lease Obligations	761,855		761,855	
Total L-T Debt/Capital Lease	2,048,540	80.1%	2,445,940	81.3%
Common Equity	508,078	19.9%	562,700	18.7%
Total Capitalization	2,556,618	100.0%	3,008,640	100.0%

UniSource Energy Corporation's
Responses To Staff's 1st Set Of Data Requests
Docket No. E-04230A-03-0933
January 26, 2004

JMR 1-9: Refer to page 8, lines 1 – 6 of the Company's application. Please provide a description of the anticipated changes in TEP's cost of debt as a result of its debt-to-equity ratio being improved from approximately 75/25 to 60/40.

RESPONSE: Please see Bates Nos. UEC000029 – UEC000030 for schedules showing (1) TEP's weighted average cost of debt as of 11/30/03 and (2) TEP's weighted average cost of debt as of 11/30/03 with pro forma adjustments for the merger. The pro forma adjustments reflect current expectations regarding debt retirements.

RESPONDENT: Kentton Grant
One South Church Avenue
Tucson, Arizona 85701

TUCSON ELECTRIC [illegible]R COMPANY
COST OF DEBT [illegible] 11/30/03

Debt Issue	(B) Due Date	(C) Amount Outstanding	(D) Unamortized Discount & Issuance Exp. (1)	(E) Balance Net of Unamortized Expenses [(C) + (D)]	(F) Interest Rate (2)	(G) Letter of Credit Fee Rate (3) *	(H) Remarketing Fee Rate	(I) Combined Interest & Fee Rate [(F) + (G) + (H)]	(J) Annualized Interest and Fees [(C) x (I)]	(K) Amort. Of Discount & Issuance Exp.	(L) Total Annual Cost [(J) + (K)]	(M) Annual Cost as % of Net Balance [(L) / (E)]
First Mortgage Bonds (Fixed Rate)												
7.50%	Aug-08	$138,300,000	($1,356,999)	$136,943,001	7.500%	N/A	N/A	7.500%	$10,372,500	$285,684	$10,658,184	7.78%
8.500%	Oct-09	$27,000,000	($63,392)	$26,936,608	8.500%	N/A	N/A	8.500%	$2,295,000	$10,545	$2,305,545	8.56%
Subtotal		$165,300,000	($1,420,391)	$163,879,609					$12,667,500	$296,229	$12,963,729	
Tax-Exempt Bonds (Fixed Rate)												
76 Farmington 7.50%	Jul-06	$21,000,000	($85,049)	$20,914,951	7.500%	N/A	N/A	7.500%	$1,575,000	$31,893	$1,606,893	7.68%
78 Farmington 6.10%	Jan-08	$33,875,000	($95,824)	$33,779,176	6.100%	N/A	N/A	6.100%	$2,066,375	$22,998	$2,089,373	6.19%
97 Farmington 6.95%	Oct-20	$80,410,000	($876,730)	$79,533,270	6.950%	N/A	N/A	6.950%	$5,588,495	$51,826	$5,640,321	7.09%
97 Coconino A 7.125%	Oct-32	$36,700,000	($410,191)	$36,289,809	7.125%	N/A	N/A	7.125%	$2,614,875	$14,185	$2,629,060	7.24%
97 Coconino B 7.00%	Oct-32	$14,700,000	($163,369)	$14,536,631	7.000%	N/A	N/A	7.000%	$1,029,000	$5,650	$1,034,650	7.12%
97 Pima A 6.10%	Sep-26	$22,460,000	($176,054)	$22,283,946	6.100%	N/A	N/A	6.100%	$1,370,060	$8,064	$1,378,124	6.18%
97 Pima B 6.00%	Sep-29	$150,000,000	($1,197,465)	$148,802,535	6.000%	N/A	N/A	6.000%	$9,000,000	$46,353	$9,046,353	6.08%
97 Pima C 6.00%	Sep-29	$75,000,000	($600,579)	$74,399,421	6.000%	N/A	N/A	6.000%	$4,500,000	$23,248	$4,523,248	6.08%
98 Apache A 5.85%	Mar-28	$83,700,000	($609,189)	$83,090,811	5.850%	N/A	N/A	5.850%	$4,898,450	$26,035	$4,921,485	5.92%
98 Apache B 5.875%	Mar-33	$99,800,000	($749,973)	$99,050,027	5.875%	N/A	N/A	5.875%	$5,863,250	$25,567	$5,888,817	5.95%
98 Apache C 5.85%	Mar-26	$16,500,000	($121,359)	$16,378,641	5.850%	N/A	N/A	5.850%	$965,250	$5,434	$970,684	5.93%
Subtotal		$634,145,000	($5,085,783)	$629,059,217					$39,468,755	$260,253	$39,729,006	
Fixed Rate Subtotal		$799,445,000	($6,506,174)	$792,938,826					$52,136,255	$556,483	$52,692,738	6.65%
Tax-Exempt Bonds (Variable Rate)												
82 Pima A - Irv. (E3991)	Oct-22	$38,700,000	($172,050)	$38,527,950	1.132%	5.955%	0.055%	7.142%	$2,763,954	$9,095	$2,773,049	7.20%
82 Pima A (D4032)	Dec-22	$39,900,000	($192,844)	$39,707,156	1.093%	5.955%	0.080%	7.128%	$2,844,072	$10,105	$2,854,177	7.19%
83 Apache A (D4170)	Dec-18	$100,000,000	($433,717)	$99,566,283	1.110%	5.971%	0.080%	7.161%	$7,161,000	$28,755	$7,189,755	7.22%
83 Apache B (D4171) (Tranc	Dec-18	$80,000,000	($342,902)	$79,657,098	1.093%	4.403%	0.080%	5.576%	$4,460,800	$22,734	$4,483,534	5.63%
83 Apache C (D4172) (Tranc	Dec-18	$50,000,000	($213,562)	$49,786,438	1.132%	4.403%	0.055%	5.590%	$2,795,000	$14,159	$2,809,159	5.64%
85 Apache A (D4526)	Dec-20	$20,000,000	($305,059)	$19,694,941	1.132%	5.939%	0.055%	7.126%	$1,425,200	$17,857	$1,443,057	7.33%
Variable Rate Subtotal		$328,600,000	($1,660,134)	$326,939,866					$21,450,026	$102,705	$21,552,731	6.59%
Revolving Credit Facility				$0	4.000%	0.350% #						
TOTAL		$1,128,045,000	($8,166,308)	$1,119,878,692					$73,586,281	$659,188	$74,245,469	6.63%

Unamortized Loss on Reacquired Debt:	($5,570,133)
Unamort Cost of 2002 Bank Agreement (Revolver):	($48,896) **
Unamort Cost of 2002 Bank Agreement (Tranche A):	
Unamort Cost of 2002 Bank Agreement (Tranche B):	($3,107,459)
Balance Net of Unamortized Loss:	$1,111,154,203

Amortization of Loss on Reacquired Debt:	$780,276	
Amort of 2002 Bank Agreement Costs (Revolver):	$46,896 **	
Amort of 2002 Bank Agreement Costs (Tranche A):	$366,416	
Amort of 2002 Bank Agreement Costs (Tranche B):	$994,620	
Total Cost with Loss Amortization:	$76,413,677	6.88%

* The effective LOC fees shown are calculated as follows (based on the new 2002 LOC Bank Agreement, which became effective 11/25/02)

Effective rate for LOC fees calculated as follows:	LOC amount	Rate	LOC fee	Bond Amount	Effec. LOC fee
82 Pima A - Irv. (E3991)	$40,078,356	5.75%	$2,304,505	$38,700,000	5.955%
82 Pima A (D4032)	$41,321,098	5.75%	$2,375,963	$39,900,000	5.955%
83 Apache A (D4170)	$103,835,616	5.75%	$5,970,548	$100,000,000	5.971%
83 Apache B (D4171) (Tranche A)	$82,888,889	4.25%	$3,522,778	$80,000,000	4.403%
83 Apache C (D4172) (Tranche A)	$51,805,556	4.25%	$2,201,736	$50,000,000	4.403%
85 Apache A (D4526)	$20,657,534	5.75%	$1,187,808	$20,000,000	5.939%
	$340,587,047		$17,563,339	$328,600,000	

** Since this issue will be fully amortized within the next 12 months, the total annual cost (L) of this item equals the amount yet to be amortized (E).

\# This fee is a commitment fee, NOT an LOC fee.

G:\Finance\Cap_res\Cost of Debt\Cost of Debt schedules\Cost of Debt Schedule_2003 with Transaction

Exhibit JMR-9
Page 2 of 3

UEC000029

TUCSON ELECTRIC ' 'ER COMPANY
COST OF DEBT AS OF 11/30/03 WITH PR :MA ADJUSTMENTS FOR MERGER

Debt Issue	(B) Due Date	(C) Amount Outstanding	(D) Unamortized Discount & Issuance Exp. (1)	(E) Balance Net of Unamortized Expenses [(C) + (D)]	(F) Interest Rate (2)	(G) Letter of Credit Fee Rate (3) *	(H) Remarketing Fee Rate	(I) Combined Interest & Fee Rate [(F) + (G) + (H)]	(J) Annualized Interest and Fees [(C) x (I)]	(K) Amort. Of Discount & Issuance Exp.	(L) Total Annual Cost [(J) + (K)]	(M) Annual Cost as % of Net Balance [(L) / (E)]
First Mortgage Bonds (Fixed Rate)												
7.50%	Aug-08	$138,300,000	($1,356,999)	$136,943,001	7.500%	N/A	N/A	7.500%	$10,372,500	$285,684	$10,658,184	7.78%
8.500%	Oct-09	$0	$0	$0	8.500%	N/A	N/A	8.500%	$0	$0	$0	
Subtotal		$138,300,000	($1,356,999)	$136,943,001					$10,372,500	$285,684	$10,658,184	
Tax-Exempt Bonds (Fixed Rate)												
76 Farmington 7.60%	Jul-06	$0	$0	$0	7.500%	N/A	N/A	7.500%	$0	$0	$0	
78 Farmington 6.10%	Jan-08	$0	$0	$0	6.100%	N/A	N/A	6.100%	$0	$0	$0	
97 Farmington 6.95%	Oct-20	$80,410,000	($876,730)	$79,533,270	6.950%	N/A	N/A	6.950%	$5,588,496	$51,826	$5,640,321	7.09%
97 Coconino A 7.125%	Oct-32	$36,700,000	($410,191)	$36,289,809	7.125%	N/A	N/A	7.125%	$2,614,875	$14,185	$2,629,060	7.24%
97 Coconino B 7.00%	Oct-32	$14,700,000	($163,369)	$14,536,631	7.000%	N/A	N/A	7.000%	$1,029,000	$5,650	$1,034,650	7.12%
97 Pima A 6.10%	Sep-25	$22,460,000	($176,054)	$22,283,946	6.100%	N/A	N/A	6.100%	$1,370,060	$8,064	$1,378,124	6.18%
97 Pima B 6.00%	Sep-29	$150,000,000	($1,197,465)	$148,802,535	6.000%	N/A	N/A	6.000%	$9,000,000	$46,353	$9,046,353	6.08%
97 Pima C 6.00%	Sep-29	$75,000,000	($600,579)	$74,399,421	6.000%	N/A	N/A	6.000%	$4,500,000	$23,248	$4,523,248	6.08%
98 Apache A 5.85%	Mar-28	$83,700,000	($609,189)	$83,090,811	5.850%	N/A	N/A	5.850%	$4,896,450	$25,035	$4,921,485	5.92%
98 Apache B 5.875%	Mar-33	$99,800,000	($749,973)	$99,050,027	5.875%	N/A	N/A	5.875%	$5,863,250	$25,567	$5,888,817	5.95%
98 Apache C 5.85%	Mar-26	$16,500,000	($121,359)	$16,378,641	5.850%	N/A	N/A	5.850%	$965,250	$5,434	$970,684	5.93%
Subtotal		$579,270,000	($4,904,910)	$574,365,090					$35,827,380	$205,363	$36,032,743	
Fixed Rate Subtotal		$717,570,000	($6,261,909)	$711,308,091					$46,199,880	$491,047	$46,690,927	6.56%
Tax-Exempt Bonds (Variable Rate)												
82 Pima A - Irv. (E3991)	Oct-22	$0	$0	$0	1.132%	5.955%	0.055%	7.142%	$0	$0	$0	
82 Pima A (D4032)	Dec-22	$0	$0	$0	1.093%	5.955%	0.080%	7.128%	$0	$0	$0	
83 Apache A (D4170)	Dec-18	$0	$0	$0	1.110%	5.971%	0.080%	7.161%	$0	$0	$0	
83 Apache B (D4171) (Tranc	Dec-18	$80,000,000	($342,902)	$79,657,098	1.093%	4.403%	0.080%	5.576%	$4,460,800	$22,734	$4,483,534	5.63%
83 Apache C (D4172) (Tranc	Dec-18	$50,000,000	($213,562)	$49,786,438	1.132%	4.403%	0.055%	5.590%	$2,795,000	$14,159	$2,809,159	5.64%
85 Apache A (D4526)	Dec-20	$20,000,000	($305,059)	$19,694,941	1.132%	5.939%	0.055%	7.126%	$1,425,200	$17,857	$1,443,057	7.33%
Variable Rate Subtotal		$150,000,000	($861,523)	$149,138,477					$8,681,000	$54,750	$8,735,750	5.86%
Revolving Credit Facility				$0	4.000%	0.360% •						
TOTAL		$867,570,000	($7,123,432)	$860,446,568					$54,880,880	$645,796	$55,426,676	6.44%

Unamortized Loss on Reacquired Debt:	($6,613,010)
Unamort Cost of 2002 Bank Agreement (Revolver):	($46,896) **
Unamort Cost of 2002 Bank Agreement (Tranche A):	
Unamort Cost of 2002 Bank Agreement (Tranche B):	($3,107,459)
Balance Net of Unamortized Loss:	$850,679,203

Amortization of Loss on Reacquired Debt:	$873,867	
Amort of 2002 Bank Agreement Costs (Revolver):	$46,896 **	
Amort of 2002 Bank Agreement Costs (Tranche A):	$366,416	
Amort of 2002 Bank Agreement Costs (Tranche B):	$994,620	
Total Cost with Loss Amortization:	$57,708,276	6.78%

* The effective LOC fees shown are calculated as follows (based on the new 2002 LOC Bank Agreement, which became effective 11/26/02.)

Effective rate for LOC fees calculated as follows:	LOC amount	Rate	LOC fee	Bond Amount	Effec. LOC fee
82 Pima A - Irv. (E3991)	$40,078,356	5.75%	$2,304,505	$38,700,000	5.955%
82 Pima A (D4032)	$41,321,096	5.75%	$2,375,963	$39,900,000	5.955%
83 Apache A (D4170)	$103,835,616	5.75%	$5,970,548	$100,000,000	5.971%
83 Apache B (D4171) (Tranche A)	$82,888,869	4.25%	$3,522,778	$80,000,000	4.403%
83 Apache C (D4172) (Tranche A)	$51,805,556	4.25%	$2,201,736	$50,000,000	4.403%
85 Apache A (D4526)	$20,657,534	5.75%	$1,187,808	$20,000,000	5.939%
	$340,587,047		$17,563,339	$328,600,000	

** Since this issue will be fully amortized within the next 12 months, the total annual cost (L) of this item equals the amount yet to be amorized (E).

• This fee is a commitment fee, NOT an LOC fee.

G:\Finance\Cap_res\Cost of Debt\Cost of Debt schedules\Cost of Debt Schedule_2003 with Transaction

UniSource Energy Corporation's
Responses To Staff's 1st Set Of Data Requests
Docket No. E-04230A-03-0933
January 26, 2004

JMR 1-15: Please provide TEP's current bond/debt rating.

RESPONSE: The following table summarizes current credit ratings for TEP:

	S&P	Moody's	Fitch
Senior Secured / FMBs	BBB-	Ba2	BB+
Bank Facility	BB+	Ba2	BB+
Unsecured	B+	Ba3	BB-
Corporate / Issuer Rating	BB	Ba3	N/A

RESPONDENT: Kentton Grant
One South Church Avenue
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Press Release **FitchRatings**

Fitch
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Fitch Ratings Affirms Tucson Electric Power; Outlook Stable
01 Dec 2003 1:04 PM (EST)

Fitch Ratings-New York-December 1, 2003: Fitch Ratings has affirmed Tucson Electric Power Company's (TEP) secured debt ratings at 'BB+' following the announcement of the proposed purchase of its parent company, UniSource Energy (UNS), in a leveraged transaction by Saguaro Utility Group L.P. (Saguaro). The Rating Outlook is Stable.

The rating action reflects the implication that Saguaro will infuse $260 million of cash into TEP that will accelerate debt reductions previously anticipated over a five-year horizon and federal and state regulatory restrictions limiting dividends between TEP and its immediate parent, UNS. Saguaro (which includes limited partners Kohlberg Kravis Roberts & Co., L.P., J.P. Morgan Partners, LLC and Wachovia Capital Partners) has agreed to acquire UNS in a transaction valued at roughly $3 billion, including assumed debt. The leveraged transaction, as planned, contemplates issuance of $660 million of debt by a new holding company that will be structured as the parent of UNS. $260 million of cash proceeds will be invested in TEP and used to reduce utility debt.

Concern regarding TEP's status as a subsidiary of a highly leveraged parent company, is mitigated by the pre-funded debt redemption feature of the merger proposal and regulatory provisions limiting dividends to 100% of the utility's net income. Fitch estimates that TEP's debt/EBITDA ratio will improve about 60 basis points to 3.9 times (x) as a result of the debt reduction, all else equal. The $260 million cash transfer and debt redemption are targeted to improve TEP's regulatory equity to 40% of total capitalization (the calculation by the Arizona Corporation Commission (ACC) excludes capitalized lease obligations) enabling the utility to dividend 100% of net income to its parent. The incremental dividend payment is partially offset by lower interest expense associated with the debt reduction.

The current ratings reflect TEP's weak interest coverage ratios, highly leveraged balance sheet and the high business risk that results from the absence of a power cost adjustment clause or deferral mechanism and the rate cap under its 1999 industry restructuring settlement agreement.

Under the terms of the merger agreement, the investor group will pay roughly $875 million for UNS equity and assume about $2.1 billion of debt. The merger is subject to ratification by shareholders and regulatory approvals are required from the ACC, FERC, the SEC and the Department of Justice under Hart-Scott-Rodino. Management will remain in place and UNS' corporate headquarters will remain in Tucson, Arizona. The merger, if approved, is expected to close within a year.

For further information on Tucson Electric Power Co. please refer to the credit analysis report dated June 18, 2003 and available on the Fitch Ratings web site at 'www.fithratings.com'.

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Moody's Investors Service

Global Credit Research
Rating Action
25 NOV 2003

Rating Action: Tucson Electric Power Company

MOODY'S CONFIRMS THE RATINGS OF TUCSON ELECTRIC POWER COMPANY (Ba2 Sr. Secured Debt) FOLLOWING $3 BILLION ACQUISITION ANNOUNCEMENT BY SAGUARO UTILITY GROUP, L.P.; RATING OUTLOOK REMAINS STABLE.

Approximately $540 Million of Debt Securities Affected.

New York, November 25, 2003 -- Moody's Investors Service confirmed the debt ratings of Tucson Electric Power Company (TEP: Ba2 Senior Secured Debt) and maintained a stable rating outlook following the announcement by TEP's parent, UniSource Energy Corporation (UniSource Energy), that it had agreed to sell 100% of the company to Saguaro Utility Group, L.P., a private equity firm, for about $3 billion, including the assumption of about $2.1 billion in debt.

Rating confirmed include:

- First Mortgage Bonds, Senior Secured Bank Credit Facility, rated Ba2;

- Issuer Rating, Senior Unsecured Debt, rated Ba3

The rating confirmation reflects the fact that TEP's standalone credit profile will likely remain unchanged following the acquisition as the utility's operating cash flow, which exceeds $200 million annually, should represent about 14% of TEP's total adjusted debt on a prospective basis. The rating action incorporates the expected improvement in TEP's capital structure following the recapitalization contemplated as part of the transaction as the utility's consolidated adjusted debt to total capitalization is anticipated to decline to approximately 70% from the current level of 82%. The rating action further considers a continued gradual decline in TEP's standalone debt over the next several years due solely from the amortization of the Springerville capital lease as a larger portion of the annual capital lease payment will be applied against the principal portion of the lease.

While these factors serve to support TEP's credit quality, the rating action also considers the fact that consolidated debt will increase by $400 million upon completion of the transaction and that any free TEP cash flow will be required to service a sizeable amount of holding company debt and to provide some level of return to the new owners. Moody's views the dividends necessary to service the $660 million of holding company debt and to provide a return to the owners as being less discretionary in nature from management's perspective. On a consolidated basis, Moody's anticipates the rating on the holding company to incorporate a consolidated view of UniSource Energy and expects funds from operations to represent about 9% of adjusted consolidated debt. Prospectively, Moody's does not anticipate a material debt reduction throughout the organization other than the previously described scheduled amortization of the Springerville lease at TEP.

Under the terms of the transaction, Saguaro, whose general partner is Sage Mountain, L.L.C. and whose limited partners include investment funds affiliated with Kohlberg Kravis Roberts & Co., L.P., J.P. Morgan Partners, LLC and Wachovia Capital Partners, will pay approximately $880 million in cash to shareholders of UniSource Energy to become UniSource Energy's sole shareholder. The cash purchase price is expected to be funded by a combination of equity contributions by the partners of Saguaro and by the issuance of debt securities and borrowings at the UniSource Energy level. The partners of Saguaro are expected to contribute approximately $557 million as common and/or preferred equity and UniSource Energy will borrow up to $660 million to fund the cash purchase price, make the $260 million of payments to TEP described below, and to pay transaction expenses. The holding company is also expected to obtain a $50 million revolving credit facility for general corporate purposes, and it is further contemplated that TEP's existing credit facility will be replaced with a new $220 million facility and that a new $40 million revolving credit facility will be made available to UniSource Energy Services and its subsidiaries.

An important condition to the transaction is the elimination of restrictions on the ability of TEP to pay dividends to the parent. In satisfying this condition, TEP's ratio of equity to total capitalization is expected to be improved to 40% (excluding capital lease obligations) at the time of the acquisition with UniSource Energy providing up to $168 million in equity contributions and repaying the $95 million note with TEP. The utility expects to use most of the equity contribution proceeds and inter company note repayment to retire some of its outstanding debt. As mentioned above, UniSource Energy will raise up to $260 million of holding company debt to be infused as equity

into TEP.

The transaction is subject to several closing conditions, including approval of the transaction by UniSource Energy shareholders and the required regulatory approvals, including approval by the Arizona Corporation Commission, the Securities and Exchange Commission, and the Federal Energy Regulatory Commission. The company anticipates the transaction closing during the third quarter 2004, and the transaction may be terminated by either party if the acquisition is not consummated by March 31, 2005.

The stable rating outlook for TEP incorporates the view that TEP will continue to provide predictable levels of cash flow for debt service over the next several years. The stable rating outlook also reflects an expectation that any free TEP level cash flow will be used for distributions to be paid to UniSource Energy for holding company debt service and for additional distributions to the new owners. As such, any material improvement in the credit quality of TEP is unlikely in the near term.

Headquartered in Tucson, Arizona, TEP is a vertically integrated electric utility serving the city of Tucson and other surrounding areas, and a wholly-owned subsidiary of UniSource Energy.

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STANDARD & POOR'S | RATINGSDIRECT

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Research:

Tucson Electric Power Co. on CreditWatch Negative on Announcement of Its Sale

Publication date: 24-Nov-2003
Credit Analyst: Anne Selting, San Francisco (1) 415-371-5009; Todd A Shipman, CFA, New York (1) 212-438-7676

(Standard & Poor's) San Francisco Nov. 24-Standard & Poor's Ratings Services today placed the ratings of Tucson Electric Power Co. (TEP; 'BB/--') on CreditWatch with negative implications following the announcement that TEP's parent, UniSource Energy Corp, (unrated) has agreed to sell 100% of the company to a private equity firm for about $3 billion, including the assumption of approximately $2.1 billion in debt.

While the proposed sale will result in the retirement of roughly $260 million in obligations at TEP, overall the transaction is expected to add an estimated $400 million in additional debt to UniSource at the holding company level.

UniSource is highly leveraged, with a debt-to-total capitalization ratio of more than 80% on a consolidated basis," said credit analyst Anne Selting. "Standard & Poor's prior stable outlook on TEP was based on the expectation that UniSource would continue to work toward reducing its overall debt burden. Now, however, TEP's ratings may be lowered in the near-term, after a thorough review of the details of the transaction, because of UniSource's unexpected move toward a leveraged buyout structure, which, regardless of whether the transaction is completed or not, raises concerns about management's commitment to credit quality."

The acquisition of UniSource is led by the investor group Saguaro Utility Group, L.P. The group's limited partners are investment funds affiliated with Kohlberg Kravis Roberts & Co. (KKR); J.P. Morgan Partners, LLC; and Wachovia Capital Partners. UniSource management would remain in place and the company's operations would not change.

The investor group has offered to purchase UniSource for an estimated $853 million, a premium of approximately 30% over current market value and 68% over book value. The partners would contribute $556 million in equity, and issue $660 million in new debt at the parent in the form of bank facilities and notes. TEP would receive up to $168 million in equity as well as repayment of a $95 million inter-company note that together would provide the utility with $260 million to retire a portion of its debt.

The recapitalization of TEP will remove current restrictions placed on the utility by the Arizona Corporation Commission (ACC) that limit TEP from dividending up to the parent more than 75% of the utility's net income. While retiring debt at the utility level will improve TEP's capital structure, the overall debt burden of the consolidated entity, including the holding company, will be increased. Standard & Poor's is concerned that the additional debt burden as proposed under the transaction will further erode credit quality. TEP's underlying credit indicators are already weak for a corporate credit rating of 'BB'. (TEP's senior secured bonds are currently rated 'BBB-').

The transaction will need to be approved by the ACC, shareholders, and the FERC, among others. The sale is also contingent on the buyers obtaining debt financing from lenders. Management is targeting to close the deal in the next six to nine months and expects to receive ACC approval no later than the third quarter of 2004.

Standard & Poor's will continue to monitor the proposed acquisition of UniSource and its family of companies and will assess the impact the sale will have on the company's credit quality once it has an opportunity to review the specifics of the transaction.

STANDARD &POOR'S | RATINGSDIRECT

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Research:
Credit FAQ: Tucson Electric Power Co.

Publication date: 11-Mar-2004
Credit Analyst: Anne Selting, San Francisco (1) 415-371-5009

Tucson Electric Power Co. (TEP; BB/Watch Neg/--) is an investor-owned utility in Arizona that serves about 360,000 electric customers in the Tucson metropolitan area. TEP is a wholly owned subsidiary of UniSource Energy Corp., which also owns UniSource Energy Services (UES), a natural gas and electric utility that serves more than 200,000 customers in northern and southern Arizona. UniSource also owns two smaller subsidiaries, Millennium Energy Holdings Inc. and UniSource Energy Development. On Nov. 24, 2003, TEP's ratings were placed on CreditWatch with negative implications.

Frequently Asked Questions

Why is TEP on CreditWatch?

Ratings were placed on CreditWatch following the announcement that parent UniSource (not rated) had agreed to be acquired by a group of private investors led by Kohlberg Kravis Roberts & Co. (KKR). KKR and its partners expect to purchase UniSource for $880 million, offering shareholders $25.25 per share, a 30% premium over the closing price in effect before the sale's announcement. As proposed, the transaction would increase UniSource's already highly leveraged consolidated capital structure by nearly $400 million. This additional leverage increases the pressure on TEP's financial profile as TEP is the principal source of funds for UniSource. It also reverses, or delays, the debt-reduction progress of the past several years, which has underpinned the stable outlook on TEP. On a consolidated basis, UniSource's outstanding debt at year-end 2003, including net lease obligations, was $1.9 billion, of which $1.8 billion was at TEP.

When will the transaction be completed?

A number of approvals are required to complete the acquisition, and management expects to receive needed authorizations during the third quarter of 2004. Approvals are needed from the Arizona Corporation Commission (ACC), the FERC, the SEC, and the Department of Justice's antitrust division. UniSource shareholders must also approve the sale, and are scheduled to vote on the transaction on March 29. On Feb. 5, the ACC opened a docket to address the issue and scheduled hearings for June 21. The merger is expected to be completed before the end of 2004.

If the acquisition is not concluded by March 31, 2005, either UniSource or KKR and its partners may terminate the acquisition. In certain circumstances, UniSource would be required to pay termination expenses of up to $25 million.

Will the acquisition strengthen TEP's financial profile?

Although the transaction would improve TEP's stand-alone capital structure, it would be accomplished through issuing additional debt by the parent, thereby increasing the leverage of the consolidated company. Specifically, the purchase is to be financed by issuing $660 million in new debt at the parent and $575 million in equity and cash. After paying about $880 million in cash to shareholders and holders of stock options, the remaining funds, net of transaction costs and other fees, would be used to retire about $260 million of debt at the utility. These funds would be made available to TEP through a cash equity injection of up to $168 million and repayment of a $95 million note from UniSource to TEP. While debt retirement at the utility level offsets some of the $660 million in new senior secured and unsecured notes to be issued by the holding company, the net effect of the proposed acquisition is to increase the UniSource family's debt burden by $400 million.

Why do the terms of the acquisition propose to retire debt at TEP while increasing it at the holding company level?

The recapitalization of TEP will remove ACC restrictions that prevent the utility from providing dividends to UniSource of more than 75% of its net income. This restriction remains in place so long as the utility's equity is below 40% of total capitalization; above this level TEP can dividend 100% of annual net income. TEP's common stock equity is currently 25%, based on the ACC approach for calculating equity ratios, which excludes capital leases from total capital. The contribution of equity and the retirement of up to $260 million in TEP debt is expected to be sufficient to reach the 40% threshold. TEP's actual common stock equity, including capital leases, is 18% of total capitalization; after the merger it is expected to increase to 28%.

How is the acquisition structured?

KKR and its partners, JP Morgan Partners LLC and Wachovia Capital Partners, will purchase the common stock and options to acquire the UniSource family of companies. Except for targeted debt retirements at TEP, all debt outstanding will remain outstanding. UniSource consists of TEP, which generates the majority of consolidated revenue, and three smaller companies, UniSource Energy Services (UES), UniSource Energy Development, and Millennium Energy Holdings Inc. UES is the holding company for UNS Gas and UNS Electric and serves 127,000 gas and 80,000 electric retail customers in Arizona. UES was formed from the purchase of the electric and gas assets from Citizens Communications Co. in August 2003. UniSource Energy Development is an unregulated company that develops generation resources. Millennium has acquired unregulated companies engaged in thin-film batteries and photovoltaic cells technology.

Post-merger, the company will be held through a limited partnership structure, Saguaro Utility Group L.P. (Saguaro L.P.). Saguaro L.P. is backed by KKR and its partners and will be operated by a general partner, Sage Mountain LLC. Saguaro L.P. will in turn own Saguaro Utility Group Corp., which will issue debt, hold the common stock of UniSource Energy, and receive the equity proceeds funneled from the investing partners to UniSource.

Does the use of a leveraged buyout structure by KKR and its partners mean that the company is troubled?

No. Financial metrics for UniSource and TEP have been relatively stable for several years. TEP benefits from operating in a rapidly growing service territory, from supportive regulatory treatment, and from healthy cash flow from operations, which it had been using to reduce its indebtedness, and thereby supporting the stable outlook. The noninvestment-grade credit rating of TEP resulted from a major generation construction program and related regulatory disallowances and deferrals that took place in the 1980s and early 1990s.

KKR's interest in this acquisition appears to be part of a slowly emerging trend of private equity interest in energy companies. Texas Pacific Group announced last year its intent to purchase Portland General Electric Co. from bankrupt Enron Corp. for $2.35 billion in cash and debt. Berkshire Hathaway Inc., which already owns MidAmerican Energy Co., has long made its interest in expanding its investment in the sector known, and has pushed vigorously for repeal of the Public Utility Holding Company Act (PUHCA) to make acquisitions of utilities by nonutility firms more palatable. KKR and its partners have indicated their intent to make UniSource a medium-term investment, with a hold horizon of about six to eight years.

KKR has made two major energy investments. In 2000, the company acquired a minority stake in DPL Inc. and in February 2003 it invested in International Transmission Holdings L.P., which owns and operates International Transmission Co., an independent transmission utility based in Michigan.

Will Standard & Poor's take a ratings action before the acquisition is complete?

TEP's ratings are under review, and a rating action may occur before the transaction closes. Because it is not known whether the acquisition will occur and what the final terms of the transaction will be, any such action would not consider the ultimate credit quality of TEP and its parent if the merger is consummated. Rather, the assessment would be based on whether TEP's current credit rating is appropriate given UniSource's willingness to add debt to an already highly leveraged balance sheet, whether or not the acquisition proceeds.

What factors will Standard & Poor's likely consider in making this decision?

TEP's financial profile is weak for its rating category, and the current ratings reflect the expectation that management would continue to aggressively pay down debt and capital lease debt obligations.

UniSource's debt to total capitalization ratio at year-end 2003 was 78%, including net obligations on TEP's capital leases. Post-merger, the ratio would increase to 80%. In absolute terms, the transaction would increase total consolidated debt by roughly 18%, relative to 2003 debt levels. Because management had expected to make debt retirements in 2004 that will not occur if the merger is consummated relative to forecast 2004 debt levels, the absolute increase in consolidated debt is expected to be higher.

Management's decision to increase debt levels as part of the acquisition strategy will be considered against several possible mitigating factors:

- Annual free cash flows at TEP after capital expenditures are projected to remain strong at at least $100 million over the next four years;
- The transaction will reduce the utility's exposure to variable rate debt by one-half to about 15%; and
- The transaction may lower TEP's regulatory risk in future rate reviews, the first of which will occur in 2004 when TEP is expected to file a transmission and distribution general rate case.

Could further rating actions occur in the near term?

Yes. There is currently no debt at the UniSource level. The parent expects to issue about $360 million in senior secured loans and $300 million in unsecured notes to finance the transaction. This will necessitate a rating for UniSource. Standard & Poor's will issue this rating once all approvals have been obtained and the debt levels and final terms of the acquisition are certain. At the time the UniSource rating is established, Standard & Poor's will also evaluate whether there are sufficient regulatory protections for TEP to warrant a separation between the parent's and utility's ratings.

What qualitative credit quality concerns would be factored into the rating of TEP and its parent if the acquisition moves forward as planned?

KKR and its partners have stated that the business of the company will not change as a result of the acquisition and that it will retain existing management, who will continue to control the company's day-to-day operations. Standard & Poor's therefore expects UniSource to continue to focus on core electric operations, make needed capital investments in its electric infrastructure, and to continue to deleverage at the holding company and utility levels.

However, UniSource will cease to have publicly traded equity, which may result in more limited public disclosure requirements, although the ACC will continue to regulate TEP. This potential lack of transparency puts particular pressure on privately held entities to have strong corporate governance structures. The recent failures of certain major U.S. corporations have shaken public and investor confidence, and have raised questions about U.S. corporate governance standards. These concerns may be heightened for UniSource, particularly because the acquisition will result in the replacement of an independent board of directors with a two-person board that will consist of Sage Mountain LLC's manager and the current CEO of UniSource.

UniSource Energy Corporation's
Responses To Staff's 1st Set Of Data Requests
Docket No. E-04230A-03-0933
January 26, 2004

JMR 1-23: Please explain how Saguaro LP/Saguaro Holdings expects to earn back such a premium on its UniSource investment.

RESPONSE: Saguaro LP/Saguaro Holdings believe the premium reflected in their acquisition price is justified by a number of factors and will be returned over time based on these primary strengths of the UniSource utility subsidiaries: (1) solid company management, (2) sound regulatory and community relationships, (3) service territory growth, (4) existing low cost generating resources and (5) sufficient internally generated funds to meet projected capital and debt service expenditures.

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Phoenix, AZ 85016

UniSource Energy Corporation's
Responses To Staff's 3rd Set Of Data Requests
Docket No. E-04230A-03-0933
March 4, 2004

JMR-3-57: Does the Company expect the officers of UniSource to have an equity interest in the post-acquisition entity? If yes, please identify the officers of UniSource that are expected to have an equity interest in the post-acquisition entity.

RESPONSE: Yes, the Company expects to offer officers an opportunity to have an equity interest in the post-acquisition entity. However, no officer has entered into any agreement, arrangement or understanding regarding the right to purchase or participate in the equity of the post-acquisition entity. If and when any such agreement, arrangement or understanding is entered into, we will supplement this response.

RESPONDENT: Frederick B. Rentschler
President, Saguaro Utility Group I Corp.
c/o Plattner, Schneidman & Schneider, P.C.
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UniSource Energy Corporation's
Responses To Staff's 4th Set Of Data Requests
Docket No. E-04230A-03-0933
March 5, 2004

JMR 4-87: Please identify all costs to TEP, UNS Gas, and UNS Electric that the Company believes can be reduced and the amount that the Company believes they can be reduced by, regardless of whether the proposed transaction occurs.

RESPONSE: TEP intends to reduce interest costs through continued de-leveraging. The amount of savings will depend on the amount of cash available for de-leveraging and the specifics of each debt retirement or lease debt purchase. With respect to operating costs, UniSource Energy's regulated subsidiaries face many of the same inflationary pressures affecting other companies and employers. Despite a keen attention to cost control and operational improvement, rising costs associated with labor, health care benefits, Sarbanes-Oxley compliance, energy procurement and other factors tend to offset specific targeted cost reductions achieved through our budgeting process. The confidential financial forecast provided in response to data request JMR 2-54 incorporates base case assumptions for operating expenses at TEP, UNS Gas and UNS Electric.

RESPONDENT: Kentton Grant
One South Church Avenue
Tucson, Arizona 85701

2.11 <u>Statement of Cash Flows</u> Please provide a proforma statement of cash flows for Saguaro Holdings for the first year after acquisition of UniSource. Identify in detail by subsidiary (i.e. TEP, UES, MEH, etc.) each source and use of funds.

RESPONSE: In 2005, Saguaro Holdings expects the following estimated cash flows:

- Receipt of \$50-\$60 million in dividends from TEP;
- Receipt of \$50-\$60 million in income tax payments from TEP and UES (\$40-\$50 million from TEP and \$5-\$10 million from UniSource Energy Services (UNS Gas and UNS Electric)); and
- Receipt of \$0-\$10 million from Millennium.

These total cash flows of \$100-\$130 million are expected to be utilized as follows:

- \$30-\$40 million outflow for consolidated income tax payments to the IRS;
- \$45-\$60 million outflow for interest expense payments for the debt obligations of Saguaro Holdings; and
- 100% of remaining cash after interest expense and tax payments for prepayment of Saguaro debt obligations.

With respect to the cash flows and cash flow utilizations described above, please note the following:

- Estimates are listed as ranges due to potential fluctuations in operating performance and the fact that the terms of Saguaro Holdings' debt securities have not yet been determined; and
- Tax payments between TEP, UES, MEH and UniSource Energy/Saguaro Holdings are assumed to be governed by the companies' current tax sharing arrangements.

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UniSource Energy Corporation's
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Docket No. E-04230A-03-0933
March 4, 2004

JMR 3-62: Does the Company plan to sell off or otherwise divest of any of the assets, subsidiaries, or investments of UniSource after the close of the proposed transaction? If yes, please identify the assets, subsidiaries, or investments that the Company plans to sell off or otherwise divest and how the proceeds will be used.

RESPONSE: The Investors have no current plans to sell or divest any of the assets, subsidiaries or investments of UniSource. The merger will not affect any current plans of UniSource Energy to sell or divest any of the assets, subsidiaries or investments of UniSource Energy in the normal course of business.

RESPONDENT: Frederick B. Rentschler
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2.15 Income Statement Provide a proforma income statement for Saguaro Utility Group for it first year of operation after the UniSource acquisition.

RESPONSE: In 2005, SaguaroUtility Group (also referred to as Saguaro Holdings), on a stand-alone basis, will have the following income statement items:

- $45-$60 million of interest expense; and
- $20-$27 million of income tax benefit.

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