

OPEN MEETING ITEM



COMMISSIONERS
MARC SPITZER - Chairman
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JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

BRIAN C. MCNEIL
Executive Secretary

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ARIZONA CORPORATION COMMISSION

2004 NOV -8 P 4: 29

DATE: November 8, 2004
DOCKET NO: E-04230A-03-0933
TO ALL PARTIES:

AZ CORP COMMISSION
DOCUMENT CONTROL

Enclosed please find the recommendation of Administrative Law Judge Jane Rodda. The recommendation has been filed in the form of an Opinion and Order on:

UNISOURCE ENERGY CORPORATION
(REORGANIZATION)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00 p.m.** on or before:

NOVEMBER 17, 2004

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

TO BE DETERMINED

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250. For more information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.


BRIAN C. McNEIL
EXECUTIVE SECRETARY

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 MARC SPITZER, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 MIKE GLEASON
7 KRISTIN K. MAYES

8 IN THE MATTER OF THE REORGANIZATION
9 OF UNISOURCE ENERGY CORPORATION.

DOCKET NO. E-04230A-03-0933

DECISION NO. _____

OPINION AND ORDER

10 DATE OF HEARING: June 21 – 25, 2004 and July 1, 2004

11 PLACE OF HEARING: Tucson, Arizona

12 PUBLIC COMMENT: June 2, 2004
Lake Havasu City & Kingman, Arizona

13 June 3, 2004
14 Prescott, Arizona

15 June 16, 2003
16 Nogales, Arizona

17 June 17, 2004
Tucson, Arizona

18 ADMINISTRATIVE LAW JUDGE: Jane L. Rodda

19 IN ATTENDANCE: Marc Spitzer, Chairman
20 William A. Mundell
21 Jeff Hatch-Miller
22 Mike Gleason
23 Kristin K. Mayes

24 APPEARANCES: Mr. Raymond S. Heyman, ROSHKA HEYMAN
& DeWULF, PLC, on behalf of UniSource
Energy Corporation;

25 Mr. Daniel Pozefsky, on behalf of the
Residential Utility Consumer Office;

26 Mr. Nicholas J. Enoch, LUBIN & ENOCH, PC,
27 on behalf of IBEW Locals Nos. 387 and 769;

28 Mr. Lawrence V. Robertson, in propria persona;

1 Mr. Marshall Magruder, in propria persona;

2 Mr. Walter W. Meek, President, Arizona Utility
Investors Association;

3 Mr. John White, Mohave County Attorney's
4 Office;

5 Mr. Marc Goldstone, Director, Punto de Vista
Property Owners Association; and

6 Mr. Christopher Kempley, Chief Counsel and
7 Ms. Lisa Vandenberg, Staff Attorney, on behalf
of the Utilities Division of the Arizona
8 Corporation Commission.

9 **BY THE COMMISSION:**

10 **The Proposed Transaction**

11 Unisource Energy Corporation ("UniSource," "Company" or "Applicant") is an Arizona
12 corporation, with its principal place of business in Tucson, Arizona. UniSource is the holding
13 company for Tucson Electric Power Company ("TEP"), UniSource Energy Services ("UES"), UNS
14 Gas, and UNS Electric, as well as other non-utility affiliates.

15 TEP is an Arizona public service corporation that provides electric generation, transmission
16 and distribution services to customers within portions of Pima and Cochise counties, Arizona. TEP's
17 principal place of business is Tucson, Arizona. UES is the owner of all the issued and outstanding
18 common stock of UNS Gas and UNS Electric. UNS Gas is an Arizona public service corporation
19 that provides retail natural gas service to approximately 125,000 customers in portions of Mohave,
20 Yavapai, Coconino, Navajo, Greenlee and Apache counties. The principal place of business for UNS
21 Gas is Flagstaff, Arizona. UNS Electric is a public service corporation that provides retail electric
22 service to approximately 77,500 customers in Mohave and Santa Cruz counties. UNS Electric's
23 principal place of business is in Kingman, Arizona.

24 UniSource's common stock is publicly traded. Over 70 percent of its shareholders are
25 institutional investors, of which ten investors own over fifty percent. (TR. at 128, AUIA-2 at 5)

26 On December 29, 2003, pursuant to A.A.C. R14-2-803, UniSource filed a Notice of Intent
27 with the Arizona Corporation Commission ("Commission"). UniSource has entered into an
28 Agreement and Plan of Merger ("Merger") with Saguaro Acquisition Corp. Saguaro Acquisition

1 Corp. is a wholly-owned subsidiary of Saguaro Utility Group I Corp. (“Saguaro Holdings”) which is
2 a wholly-owned subsidiary of Saguaro Utility Group L.P., an Arizona limited partnership (“Saguaro
3 LP”). The general partner of Saguaro LP is Sage Mountain LLC (“Sage”) and its limited partners are
4 investment funds affiliated with Kohlberg, Kravis Roberts & Co., L.P (“KKR”), J.P. Morgan Partners
5 (“JPMP”) and Wachovia Capital Partners. (“WCP”)¹

6 KKR is a private investment firm headquartered in New York, London and Menlo Park,
7 California. The primary investors in KKR affiliated investments funds are institutions, including
8 state and corporate pension funds, banks, insurance companies and university endowments. After
9 completion of the proposed Merger, KKR affiliated investment funds would own approximately 62
10 percent of the equity in Saguaro LP. (Notice of Intent at 4; TR at 423)

11 JPMP is an indirect, wholly-owned subsidiary of J.P. Morgan Chase & Co., one of the largest
12 financial entities in the United States. After completion of the proposed Merger, investment funds
13 and other entities affiliated with JPMP would own approximately 31 percent of the equity in Saguaro
14 LP. (Notice of Intent at 3; TR at 428-429)

15 WCP is the principal investing group of Wachovia Corporation, the nation’s fifth largest
16 financial holding company. After completion of the proposed Merger, investment funds affiliated
17 with WCP would own approximately 7 percent of the equity in Saguaro LP. (Notice of Intent at 4.
18 TR at 429)

19 Sage is an Arizona limited liability company, owned and managed by Frederick B.
20 Rentschler, the former president and chief executive officer of Armour-Dial, Beatrice Companies and
21 Northwest Airlines. Mr. Rentschler is a resident of Maricopa County, Arizona. (Notice of Intent; TR
22 at 816-818, 824)

23 In addition, it is expected that members of UniSource’s senior management would own
24 Saguaro Holdings common stock.

25 Upon completion of the proposed Merger, Saguaro Acquisition Corp. would cease to exist
26 and UniSource would be the surviving entity. (Notice of Intent at 3, A-1 at 19) A copy of the

27 _____

28 ¹ KKR, JPMP and WCP are often referred to herein as the “Investors.”

1 organizational chart of the proposed post-merger structure is attached as Exhibit A. Each outstanding
2 share of UniSource's common stock would be converted into the right to receive \$25.25, and Saguario
3 Holdings would become UniSource's sole shareholder. (A-1 at 19) There would be no change in
4 ownership of UniSource's subsidiaries as a result of the merger.

5 After the proposed Merger, Saguario Holdings would have a Board of Directors consisting of
6 two members, Mr. James Pignatelli, UniSource's current Chief Executive Officer, and Mr.
7 Rentschler. UniSource would have a Board of Directors comprised of four members, two of whom
8 would be Messrs. Pignatelli and Rentschler, and two of whom would qualify as independent of
9 UniSource, Saguario Holdings, Saguario LP, any of Saguario LP's partners and KKR, JPMP and WCP
10 and entities they control. (TR at 851)

11 TEP, UES, UNS Gas and UNS Electric would each have a Board of Directors comprised of at
12 least five members, at least two of whom would be Arizona residents and two of whom would be
13 independent. (TR at 835-837; A-3 at 6) Mr. Pignatelli testified that it was the intention to bring
14 existing UniSource board members onto the new boards. (TR at 152)

15 At the closing of the proposed Merger, the limited partners of Saguario LP would provide
16 aggregate capital contributions to the partnership of up to \$555.7 million, and the general partner
17 would provide a capital contribution of approximately \$1 million. (Notice of Intent at 5) Saguario LP
18 would provide Saguario Holdings with an equity contribution of up to \$556.7 million. In addition,
19 Saguario Holdings would borrow up to \$660 million, which would fund the cash purchase price, fund
20 the cash infusion to TEP and pay transaction expenses. The borrowing would include up to \$360
21 million in senior secured bank loans and up to \$300 million in debt securities at closing. (S-1 at 7)

22 Saguario Holdings would provide a capital contribution of approximately \$1.2 billion to
23 Saguario Acquisition/UniSource (\$556.7 million in equity and \$660 million in borrowings).
24 Approximately \$880 million of these funds would be paid to UniSource's existing stock and option
25 holders and up to \$263 million would be infused into TEP to improve its debt/equity ratio to 60/40.
26 (S-1 at 8) The net effect would be an equity infusion of up to \$263 million into TEP.

27 In addition, after closing TEP would have available a \$60 million revolving credit facility,
28 and Saguario Holdings would make available a \$40 million revolving credit facility to UES (currently

1 it does not have any revolving credit facility) and a \$50 million revolving credit line to UniSource.
2 The parties to the proposed Merger also agreed that TEP's and UniSource's management and
3 corporate headquarters would remain in Tucson; and TEP, UNS Gas and UNS Electric would not
4 guarantee the obligations of UniSource. (A-1 at 2-3)

5 After receiving the comments of Commission Utilities Division Staff ("Staff") and the
6 Residential Utility Consumer Office ("RUCO") in their direct testimony, UniSource presented
7 numerous conditions that it believed would address the concerns of Staff and RUCO. (A-2) The
8 commitments and conditions that UniSource has agreed to as part of the proposed Merger are set
9 forth in Exhibit B, attached hereto and incorporated herein. (A-3) The proposed conditions include
10 terms and commitments intended to safeguard the financial integrity of the utilities often referred to
11 as "ring-fencing"; service quality and reliability; relationships between affiliates; corporate
12 governance, oversight and community presence; and the non-recoverability of merger and affiliate
13 costs.

14 Procedural History

15 By letter dated January 9, 2004, UniSource waived the 60-day period for determining whether
16 a hearing should be held under A.A.C. R14-2-803, and requested that a hearing be conducted.

17 By Procedural Order dated January 21, 2004, the Hearing Division scheduled a Procedural
18 Conference to establish the procedural guidelines for this matter.

19 On January 29, 2004, UniSource and Staff filed a Joint Request for Procedural Schedule.

20 The Procedural Conference convened on February 4, 2004, with UniSource, Staff and RUCO
21 participating. The parties agreed upon the proposed schedule. The Procedural Order dated February
22 5, 2004, established the testimony filing deadlines and set a hearing date.

23 Intervention was granted to RUCO, the International Brotherhood of Electrical Workers
24 ("IBEW") Locals Nos. 387 and 769, the Arizona Utility Investors Association ("AUIA"), Mohave
25 County, the Punta de Vista Property Owners Association, Laughlin Ranch LLC, the Mohave Valley
26 Elementary School District, and the following individuals: Lawrence V. Robertson, Marshall
27 Magruder, and Billy Burtnett.

28 Public Comment meetings were held in Lake Havasu City and Kingman, Arizona on June 2,

1 2004; in Prescott on June 3, 2004; in Nogales on June 16, 2004; and in Tucson on June 17, 2004.
2 Additional public comment was taken prior to the commencement of the hearing.

3 Pursuant to the February 5, 2004 Procedural Order, UniSource filed the direct testimony of
4 James Pignatelli on February 13, 2004; AUIA filed the testimony of Walter Meek, RUCO filed the
5 testimony of Marylee Diaz-Cortez and Staff filed the testimony of Joel Reiker and John Antonuk on
6 April 30, 2004; UniSource filed the rebuttal testimony of Mr. Pignatelli and Scott Stuart, a member
7 of KKR on May 25, 2004; Staff filed the surrebuttal testimony of Mr. Antonuk and RUCO filed the
8 surrebuttal testimony of Ms. Diaz-Cortez on June 11, 2004.

9 The hearing convened as scheduled on June 21, 2004, at the Commission's offices in Tucson,
10 Arizona.

11 UniSource, RUCO, Staff, IBEW and AUIA filed Initial Briefs on July 30, 2004. Mohave and
12 Mr. Magruder docketed their Briefs on August 5, 2004. UniSource, AUIA, RUCO and Staff filed
13 Reply Briefs on August 16, 2004.

14 During the hearing the issue of the discoverability and disclosure of certain reports
15 commissioned or prepared by the Investors arose. Although the parties to the case did not pursue
16 Motions to Compel, two Commissioners who attended the hearing believed that the reports might be
17 relevant to their analysis of the proposed reorganization. By Procedural Order dated September 24,
18 2004, a Procedural Conference convened on September 28, 2004, at the Commission's Phoenix
19 offices, for the purpose of discussing whether, and under what terms, the subject reports could, or
20 would, be made available to the Commission.

21 **Positions of the Parties**

22 **UniSource**

23 UniSource argues that the applicable standard for reviewing the proposed Merger is the so-
24 called "No Harm Rule" established in the Commission's Affiliated Interest Rules. A.A.C. R14-2-
25 803(C) ("Rule 803(C)"). The Affiliated Interest Rules require that any utility or affiliate provide
26 prior notice to, and obtain the approval of, the Commission for any reorganization of an existing
27 public utility holding company. Rule 803(C) provides:

28 At the conclusion of any hearing on the organization or reorganization of a

1 utility holding company, the Commission may reject the proposal if it
 2 determines that it would impair the financial status of the public utility,
 3 otherwise prevent it from attracting capital at fair and reasonable terms, or
 4 impair the ability of the public utility to provide safe, reasonable and
 5 adequate service.

6 UniSource argues that Rule 803(C) defines the “public interest” to be protected during the
 7 reorganization of a utility holding company. UniSource further argues that there is no statute, ruling
 8 or regulation that imposes additional requirements to those established in Rule 803(C) for
 9 Commission approval of the reorganization of a utility holding company or that provides a different
 10 standard than Rule 803(C). Thus, according to UniSource, the Commission should approve the
 11 proposed Merger unless the evidence demonstrates that the Merger will:

- 12 1. impair the financial status of TEP, UNS Gas or UNS Electric;
- 13 2. prevent TEP, UNS Gas or UNS Electric from attracting capital at fair and
 14 reasonable terms; or
- 15 3. impair the ability of TEP, UNS Gas or UNS Electric to provide safe, reasonable
 16 and adequate service.

17 UniSource notes that the Commission applied Rule 803(C) in (1) the UniSource Holding Company
 18 Order (Decision No. 60480 (November 23, 1997) at 3); (2) the “Arizona-American/RWE Order”
 19 (Decision No. 65453 (December 16, 2003) at 19); (3) the “Qwest/US West Order” (Decision No.
 20 62672 (June 30, 2000) at 30); and (4) the “XO Long Distance Services, Inc. Order” (Decision No.
 21 65520 (January 17, 2003) at 2).

22 Unisource asserts that the purpose of the Affiliated Interest Rules is to ensure that the Merger
 23 will not harm utilities and cause customers to pay higher rates. In *Arizona Corp Comm’n v. State ex*
 24 *rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992), the Arizona Supreme Court upheld the authority of
 25 the Commission to promulgate the Affiliated Interest Rules to protect customers from economic
 26 harm. With respect to the Affiliated Interest Rules, the Arizona Supreme Court said:

27 The Proposed Rules arguably prevent utilities from endangering their
 28 assets through transactions with their affiliates. If such transactions
 damage a utility company’s assets or net worth, the company will have to
 seek higher rates for survival. Thus, transactions with affiliated
 corporations could have a direct and devastating impact on rates . . . [We]
 believe the Commission’s regulatory power permits it to require
 information regarding, and approval of, all transactions between a public
 service corporation and its affiliates that may significantly affect economic

1 stability and thus impact the rates charged by a public service corporation.
 2 171 Ariz. at 295.

3 In adopting the Affiliated Interest Rules, the Commission stated that the purpose for the rules
 4 is:

5 To ensure that ratepayers do not pay rates for utility service that include
 6 costs associated with the holding company structure, financially
 7 beleaguered affiliates, or sweetheart deals with affiliates intended to
 8 extract capital from the utility to subsidize nonutility operations.
 9 (Decision No. 56844, Attachment B at 2)

10 UniSource states that Staff has acknowledged that under the Affiliated Interest Rules, the
 11 Commission is not required to find short-term tangible benefits for customers in the form of rates and
 12 services, or comparable benefits to the shareholders and customers, to approve the Merger. (A-12; A-
 13 13) Indeed, UniSource argues, the Affiliated Interest Rules were never intended to require that a
 14 reorganization provide benefits to one party or another, rather they were implemented to advance the
 15 following principles:

16 First, utility funds must not be commingled with non-utility funds.
 17 Second, cross-subsidization of non-utility activities by utility ratepayers
 18 must be prohibited. Third, the financial credit of the utility must not be
 19 affected by non-utility activities. Fourth, the utility and its affiliates must
 20 provide the Commission with the information necessary to carry-out
 21 regulatory responsibilities. (Decision No. 56844; Attachment B at 3,
 22 Attachment C at 1.)

23 To employ a different standard than established in Rule 803(C), UniSource asserts, would
 24 violate its due process rights. According to UniSource, due process requires that when an agency is
 25 charged with implementing or interpreting legislation, the “standards” must be expressed in a rule or
 26 regulation filed and published pursuant to law. UniSource cites *Hallmark Cards, Inc. v. Kansas Dept.*
 27 *of Commerce & Housing*, 88 P.3d 250, 257 (Kan. App. 2004), where the court held:

28 [W]here the statute itself contains a clear command that the agency
 proceed by rulemaking, failure to promulgate regulations specifying
 comprehensive and complete standards coupled with an application of
 informal standards on a case-by-case basis, may lead to the agency action
 being stricken as arbitrary, capricious, and otherwise not in accordance
 with law.

UniSource asserts that in the context of this proceeding, rewriting the standard of Rule 803(C) to
 contain other terms, conditions or requirements would be tantamount to adopting a new rule without
 following the proper procedure.

UniSource asserts that there is no evidence in this docket that indicates the proposed Merger

1 would harm or impair the UniSource affiliates. First, UniSource argues, the proposed Merger would
2 not impair the financial status of TEP, UNS Gas or UNS Electric because the proposed Merger would
3 not require any affiliated utility to incur any additional debt and would not require the utility affiliates
4 to guarantee or pledge any assets. Rather, UniSource points out, as a result of the proposed Merger
5 TEP would receive an immediate infusion of \$263 million, which would be used to pay down TEP
6 debt. (TR at 108) TEP's debt/equity ratio would improve from 25 percent equity to 40 percent
7 equity. In addition, as a result of the Merger, UniSource claims that TEP, UNS Gas and UNS
8 Electric would benefit from increased liquidity as a result of new credit facilities of \$50 million and
9 \$40 million. (AUIA-2) Thus, UniSource asserts, the Merger would remove financial risk from
10 UniSource customers and shift that risk to the Investors. UniSource states that the "ring-fence"
11 provisions of the Merger ensure that the risk would not shift back to the customers. (TR at 427)

12 Second, UniSource argues, the proposed Merger would not prevent UniSource affiliates from
13 attracting capital on fair and reasonable terms. Rather, it claims the proposed Merger would enable
14 the utilities to attract capital at better terms than before, as the financially-improved TEP would be in
15 a stronger position to negotiate better terms for necessary capital than before the Merger. UNS Gas
16 and UNS Electric would have the benefit of a \$40 million, 5-year revolving loan. Mr. Pignatelli
17 testified that TEP was able to secure better terms than previously experienced when it refinanced its
18 \$400 million credit facility as a result of the Investors participation and ability to bring a broader
19 group of lenders and a greater pool of capital. (TR at 406-408, 724-725)

20 UniSource claims that many aspects of the proposed Merger would improve the operations
21 and service of its utility affiliates. For example, the proposed conditions specify that UniSource and
22 its utility affiliates would be locally managed and headquartered, assets would be managed to
23 accommodate service territory growth, and capital would be invested to provide safe, reliable and
24 adequate service to customers. (Notice of Intent at 10-11) Other conditions would obligate
25 UniSource's utility affiliates to spend at least \$1.5 billion in operating and maintenance expenses and
26 capital expenditures for the years 2005-2008 and require TEP to make at least \$400 million of
27 voluntary debt and lease prepayments and buybacks prior to December 31, 2008. (A-3 at 1, 5)

28 UniSource argues that it is clear the proposed Merger meets the standards of Rule 803(C), but

1 that even if the Commission relied on a more expansive standard based on other “public interest”
2 factors, the terms and conditions of the proposed Merger, viewed as a whole, meet and exceed any
3 reasonable definition of the public interest as both shareholders and consumers receive benefits.

4 UniSource asserts that its shareholders would receive fair value for their shares. The Merger
5 purchase price of \$25.25 per share, is approximately 30 percent higher than the UniSource closing
6 price per share on the day prior to the Merger announcement. The Investors believe that the
7 UniSource stock was undervalued by the market because the stock market undervalues small
8 capitalization stock and focuses on the short term. They believe that while they would pay a
9 premium to the market price, they would not be paying a premium to the intrinsic value of the
10 company. (TR at 482) UniSource argues that its shareholders have invested in good faith in the
11 company, borne the risk that their investment would decrease or increase, and provided necessary
12 funds to permit the company to continually provide safe, reliable and adequate service, even during
13 difficult times. Therefore, according to UniSource, it is just and equitable for its shareholders to
14 receive a fair price for their stock in the proposed Merger.

15 UniSource also asserts that customers are receiving substantial and significant benefits from
16 the Merger, including economic benefits, continuity and stability of management and stronger
17 utilities. Current management would receive a five-year employment contract and, according to
18 UniSource, the cost of capital would go down because of the equity infusion and the involvement of
19 the Investors’ access to financial resources. (TR at 666-667, 670-671) Again, UniSource argues the
20 risk of operations is being shifted from the customers to the Investors. UniSource states the benefits
21 to customers come at no cost to them as the utility affiliates have agreed not to seek recovery in any
22 future rate case of the costs of the Investors before or after the Merger and from the Investors’
23 agreement not to seek recovery of any acquisition premium. (A-3)

24 The Investors testified that they would not change the management direction of the company,
25 and that they believe the foremost duty of a public service corporation is to serve the public. (TR at
26 452) The Investors claim that they are patient, long-term investors who do not plan on managing the
27 day-to-day operations of UniSource. (A-5 at 4; TR at 421) They testified their average holding
28 period for investments is approximately 7-8 years, although some investments have been held as long

1 as 10 to 20 years. (A-5; TR at 421) The Investors stated that they do not anticipate taking current
2 dividends and would be making their return on their investment by selling the company at some
3 future date. (TR at 446)

4 UniSource cites a number of detrimental consequences that may occur if the authority for the
5 Merger were to be denied. The Company claims that the utility affiliates would remain in a weaker
6 financial condition than otherwise; there would be fewer financing options as current participants
7 would likely withdraw (TR at 653-4); there would be no guarantees that Mr. Pignatelli would remain
8 a part of senior management; and there would be uncertainty whether the \$1.5 billion in capital
9 investment would occur, or that the Company could, or would, maintain its community presence and
10 support. (TR at 185) UniSource also takes up AUIA's warnings that denial would be a signal to the
11 financial community worldwide that Arizona is not a particularly receptive place for capital
12 investment. (TR at 732-3; UniSource Reply Brief at 3-4)

13 AUIA

14 AUIA argues that it is incumbent upon the Commission to approve an application to
15 reorganize a utility holding company unless it finds that the public utility or its customers will be
16 damaged by the transaction. AUIA asserts that the record in this case indicates that contrary to
17 causing harm, in actuality, substantial benefits, financial and otherwise, will accrue to the UniSource
18 subsidiaries, and that every conceivable risk to the utilities beyond ordinary business risk has been
19 addressed by the conditions that UniSource and the Investors have accepted. AUIA believes that by
20 adopting a neutral position neither supporting nor supposing the merger, Staff acknowledges that
21 there is no evident consumer risk in the transaction.

22 AUIA asserts that the benefits of the transaction are clear: the infusion of \$263 million of
23 new capital into TEP; the improvement of TEP's debt equity position; and the increased liquidity
24 from \$90 million in new credit lines to UniSource and UES. AUIA believes that TEP and its
25 customers will benefit in the future from improved credit ratings and a lower cost of debt. In
26 addition, AUIA asserts the assurance of management continuity is a distinct benefit. Mr. Pignatelli
27 has stated that his ability to operate as CEO could improve post merger as the institutional investors
28 that currently hold 70 percent of UniSource's stock would no longer be applying constant pressure

1 for financial performance. (TR at 105) Although AUIA believes that the incremental financial risks
2 of the proposed leveraged buyout have been overstated in this case, the “ring-fencing” conditions the
3 Company has accepted will assure that TEP would benefit from improved capital ratios; would
4 establish clear separation of the utility subsidiaries from UniSource, Saguaro Holdings, and Saguaro
5 LP; assure that the subsidiaries would not assume responsibility for the obligations of the parent or
6 any UNS affiliate; and would shield the assets of the utility companies from any financial failure at
7 the holding company level. AUIA notes that Mr. Pignatelli has committed that TEP would not
8 attempt to recover from ratepayers any increase in the cost of debt that can be ascribed to this
9 transaction. (A-1 at 6)

10 AUIA believes that the fact that the Investors are willing to invest equity in an Arizona utility
11 and the community it serves is a broad communication to the investment community that Arizona
12 has a positive investment climate.

13 AUIA argues that the Commission has defined the public interest standard in its own rule
14 R14-2-803 (C), and the Applicant has a right to rely on it.

15 **Staff**

16 Staff has recommended a number of conditions, attached hereto as Exhibit C, all of which
17 Staff believes are necessary if the Commission determines to approve the reorganization. Staff
18 would oppose the proposed Merger if its recommended conditions are not adopted. Even if all of
19 Staff’s recommended conditions are adopted, Staff is neutral on whether the reorganization should
20 be approved. Staff believes that the conditions UniSource proposed are critical components of the
21 transaction, but fall short in several areas. Staff believes the areas that need strengthening include
22 the amount of debt reduction at TEP through 2008; bankruptcy protection for the utility affiliates;
23 how to determine the appropriate level of operation sand maintenance expenditures; Commission
24 approval for changes in the limited partners; and how to define community support. Staff argues that
25 any differences between the conditions agreed to by the Company and recommended by Staff are not
26 “immaterial, pedantic or subtle.” (TR at 1068) According to Staff, a failure to close the remaining
27 gaps “would leave customers unduly exposed to risks in the wake of this reorganization.” (Id.) Staff
28 asserts that if the matter is approved, the conditions placed upon the approval will be essential tools

1 for the Commission in turning UniSource's stated intentions into enforceable terms. Only those
2 conditions where UniSource and Staff do not agree are addressed below.

3 Condition No. 1.d – Debt Reduction

4 UniSource has agreed as a condition to the proposed Merger to reduce TEP's current debt and
5 lease obligations. In particular, UniSource has committed that TEP would make at least \$300
6 million of voluntary debt and lease prepayments and buybacks from January 1, 2004, to December
7 31, 2005, (which includes the cash infusion and debt retirement associated with the merger
8 transaction) and a total of at least \$400 million of such prepayments and buybacks prior to December
9 31, 2008. Specifically, UniSource proposes the following as its Condition No. 1.d:

10 TEP will continue its policy of reducing its current debt and lease
11 obligations. In particular, TEP will make at least \$300 million of
12 voluntary debt and lease prepayments and buybacks from January 1, 2004
13 to December 31, 2005 (which includes the cash infusion and debt
14 retirement associated with the merger transaction) and a total of at least
15 \$400 million prior to December 31, 2008. These reductions are in
16 addition to lease debt amortization included in currently scheduled capital
17 lease obligations. Any new TEP debt issuances must be approved by the
18 ACC. In relation to TEP first mortgage bonds which mature in 2008, TEP
19 shall submit to the Director, Utilities Division by March 31, 2008, a report
20 stating its intentions and reasons for the pay-off or refinancing of such
21 debt.

22 Staff recommends increasing the amount of the total debt reduction to \$500 million,
23 proposing the following:

24 Unless otherwise first approved by the Commission, TEP will make total
25 net reductions in its long-term debt and capital lease debt of at least \$500
26 million by the end of the calendar year 2008, which includes an average of
27 \$300 million of annual voluntary debt and lease prepayments and
28 buybacks between 2006 and 2008. At least \$300 million of the net
reduction in long-term debt and capital-lease debt shall occur by the end of
calendar year 2005. The required net reductions in TEP's long-term and
capital lease debt shall be in addition to lease debt amortization included
in currently scheduled capital-lease obligations. (Attachment C A.1.d)

Staff asserts that this condition merely turns UniSource's own words about the process of
rebuilding the financial health of TEP into enforceable terms.

UniSource responds that the prepayments and buybacks are not the only debt reductions that
will take place from 2005-2008. UniSource reports that it will be reducing its debt by another \$200
to \$300 million in normal scheduled payments during that time. Mr. Pignatelli was reluctant to

1 commit to an additional \$100 million in prepayments and buybacks for fear it would hamper the
2 Company's ability to meet upcoming needs. (TR at 117-18) UniSource argues management needs
3 flexibility to prudently operate the utility affiliates.

4 Condition No. 2.b – Bankruptcy Protection

5 Staff recommends language that provides that “all Saguaro and UniSource debt will include
6 separateness covenants, which will remain effective as long as TEP and UES are owned by Saguaro
7 and UniSource” (Attachment C at A.2.b) Staff argues this provision is required to protect the
8 utility affiliates from falling into jeopardy due to the actions of affiliates so that neither the utilities
9 nor their customers should be exposed to bankruptcy risk due to the proposed Merger. In response
10 to UniSource's objection that lenders will charge a premium if Staff's language is inserted into loan
11 agreements, and that Staff's proposed language is not commercially feasible, Staff recommends that
12 UniSource have the ability to seek a waiver of this provision, but that if a waiver is sought and
13 granted, the Commission should require a specified form of compensation for the utility customers.

14 UniSource has agreed to use its reasonable best efforts to ensure that all material debt
15 facilities entered into after the date of the proposed Merger will include separateness covenants or
16 acknowledgements, which would state in substance that lenders to Saguaro Holdings and
17 UniSource acknowledge that Saguaro Holdings and UniSource are separate legal entities from the
18 utilities; and that lenders are relying for legal credit support for loans solely on the credit worthiness
19 of Saguaro Holdings and UniSource. (Attachment B at A.2.b)

20 UniSource argues that Staff's proposed Condition No. 2.b is based on incorrect assumptions.
21 According to UniSource, the debt reduction at TEP combined with the proposed conditions agreed
22 to by Unisource would create a decreased level of risk that any UniSource utility affiliate will be
23 involved in a bankruptcy proceeding. (UniSource Reply Brief at 14) UniSource asserts there is no
24 evidence in the record that the proposed Merger would in any way increase the utilities' exposure to
25 bankruptcy.

26 UniSource argues that Staff's proposal that a waiver be granted only if UniSource can
27 provide a benefit as compensation to consumers of the added risk is not reasonable. UniSource
28 claims the risks of bankruptcy exist absent the Merger, and that any risk is mitigated by the

1 Affiliated Interest Rules and the UniSource Holding Company Orders.

2 Furthermore, UniSource argues it is “highly doubtful” that a judge would join the utility
3 affiliates in a bankruptcy filing in light of the overwhelming evidence establishing the legal
4 separateness of the entities, including: the (1) Affiliated Interest Rules; (2) UniSource’s Holding
5 Company Order; (3) ring fencing conditions; (4) utility affiliates’ amended organizational
6 documents; (5) Commission Order approving the Merger; and (6) operating history of the entities.

7 In addition, UniSource does not believe that Staff’s proposed Condition No. 2.b is
8 commercially feasible as UniSource does not have control over what lenders agree to. (TR at 121,
9 355-56) UniSource could not find any other financing documents that contain the language Staff is
10 proposing. UniSource claims that its objection to Staff’s proposed language is not that lenders
11 would charge a premium for the extra risk, but rather that lenders would not accept the language at
12 all. UniSource believes the mechanism of requiring a waiver will actually impair the ability to
13 attract capital by unnecessarily complicating and extending the approval process.

14 In addition to UniSource’s proposed Condition No. 2.b, UniSource has offered to include in
15 the disclosure for the \$300 million offering that is contemplated in connection with the proposed
16 Merger, and in subsequent financing offering memoranda, the following concepts:

17
18 (i) Saguaro Utility Group I is a holding company and will conduct its
19 operations primarily through wholly-owned subsidiaries; (ii) substantially
20 all of the consolidated assets of Saguaro Utility Group I are held by these
21 subsidiaries; (iii) the subsidiaries are separate and distinct legal entities
22 and have no obligation to pay any amounts due with respect to the notes or
23 to provide Saguaro Utility Group I with funds for such payment or other
24 payment obligations of Saguaro Utility Group I; (iv) because Saguaro
25 Utility Group I is a holding company, its obligations with respect to the
26 notes are structurally subordinated to all existing and future liabilities of
27 its subsidiaries; (v) the rights of Saguaro Utility Group I and its creditors
28 including the rights of the holders of the notes, to participate in the assets
of any subsidiary in the event that such a subsidiary is liquidated or
reorganized, are subject to the prior claims of such subsidiary’s creditors;
and (vi) to the extent that Saguaro Utility Group I may be a creditor with
recognized claims against any such subsidiary, its claims would still be
subject to the prior claims of such subsidiary’s creditors to the extent that
they are secured or senior to those held by Saguaro Utility Group I.

27 Additionally, UniSource states it would provide to lenders under its existing Saguaro Credit
28 Agreement (“SCA”), prior to draw down, the following:

- 1) copies of the UniSource utility affiliates' organizational documents as amended to include the "ring fencing" provisions;
- 2) the Commission's Order approving the Merger; and
- 3) a written statement from UniSource indicating that the UniSource utility affiliates are each operated as a separate corporate and legal entity and that the assets of the UniSource utility affiliates are not available to satisfy any claims creditors may have under the SCA.

UniSource notes that the SCA, negotiated in March 2004, was structured to grant lenders a security interest only in the common stock of UniSource and its non-utility subsidiaries and does not provide for a security interest in any of the common stock or assets of TEP, UNS Gas and UNS Electric.

Condition No. 4 – Minimum O&M Expenditures and Capital Commitments

Staff was concerned about UniSource's commitment, as originally expressed, to invest "adequate capital" to provide safe, reliable and adequate service. Staff believed this commitment is overly vague. Thus, Staff proposed the following:

- a. TEP, UNS Electric and UNS Gas shall fund a Commission-sponsored management and operations audit to commence not more than 18 months after the ownership transfer, to be conducted by Staff from a firm selected by the Commission, with the funding amount not less than \$400,000. (Antonuk Dir. at 67-68)
- b. UniSource shall maintain accounting and business management records in the same form as kept now, unless approved by the Commission. (Antonuk Dir. at 68)

UniSource could not accept Staff's proposed language, and subsequently proposed the following:

TEP, UNS Electric and UNS Gas will not, without the prior approval of the Commission, spend less than an aggregate amount of approximately \$1.5 billion in operating and maintenance expenses and capital expenditures for the years 2005-2008 (which equates to a yearly average level of \$375 million for those years). TEP will submit a report annually in 2006 to 2009 to the Director, Utilities Division describing the prior year's expenditures and statistics on customer and usage growth.

UniSource's response was to commit to spend \$1.5 billion in capital investment for 2005-2008, rather than agree to Staff's recommended management and operational audit. Staff, however,

1 does not believe there is a currently available measure to begin to adequately assess whether
2 UniSource's offered dollar amount is too much or too little.

3 In response to Staff's concerns, UniSource states that there was no evidence to contradict Mr.
4 Pignatelli's assessment of the proper amount necessary to plan, construct, maintain and operate the
5 electric systems of the UniSource utility affiliates. UniSource argues that Staff's alternative, to
6 spend \$400,000 on an external management audit is far less beneficial to UniSource. UniSource
7 believes that its assurance to continue providing safe, reliable and adequate service, its reporting
8 requirements, and the fact that its utility affiliates will be regularly before the Commission in rate
9 proceedings between 2005-2008, provide more than adequate monitoring protections.

10 Condition No. 11 – Commission authority over non-utility investments

11 Staff believes that an important step to ensuring the financial strength of UniSource's utilities
12 is through a measured Commission review of non-utility investments. Staff states that while the
13 Applicant does not appear to oppose Commission review, its proposed language removes energy
14 investments from Commission review without explanation. UniSource proposed the following
15 condition:

16 Saguaro LP, Saguaro Holdings and UniSource Energy will not,
17 without prior Commission approval, make any new, material non-
18 regulated, non-utility investments (other than investments in
19 Millenium Ventures) that are not part of the electric energy
20 business. (Attachment B No. 11)

21 Staff proposes the following:

22 Saguaro LP, Saguaro Holdings and UniSource Energy will not,
23 without prior Commission approval, make any new, material non-
24 regulated, non-utility investments, other than those required to
25 provide utility service. (Attachment C, No. 11)

26 Staff asserts that recent history shows the energy business is one of the country's most
27 volatile, and far more risky than the regulated utility business. Staff argues that Applicant's
28 omission of such energy transactions undermines the protections this condition should provide. Staff
believes that providing the Commission the opportunity to review any non-utility investment not
directly related to the provision of utility service merely aids the Applicant in accomplishing its
intent by protecting against potential harm to the financial strength of the utilities from non-utility
investments.

1 In its Reply Brief, UniSource accepted Staff’s proposed language. (UniSource Reply Brief at
 2 7-8) Under Staff’s proposed Condition No. 11, UniSource believes that it would be able to continue
 3 funding ongoing investments in existing affiliates such as Global Solar, without prior Commission
 4 approval, but would first seek Commission approval for new material non-regulated, non-utility
 5 investments.

6 Condition No. 13 – Commission Approved Material Changes to Saguaro LP Limited Partners

7 UniSource proposed the following condition concerning the transfer of ownership interests:

8 Saguaro LP will not permit any ownership change among its limited
 9 partners without prior Commission approval if such change would
 10 result in any new limited partner(s) obtaining in aggregate more
 11 than 10 % of the economic interests in Saguaro LP (other than
 limited partners who are affiliates of existing limited partners or are
 managed by the same general partner or member or Affiliate thereof
 prior to such ownership change). (TR 594-595)²

12 Staff criticizes the proposed language on the grounds that the parenthetical exempts transfers from
 13 Commission approval to such an extent that the condition is virtually unenforceable. For example,
 14 Staff notes it exempts any affiliate of any existing limited partner, but there is no description of how
 15 “affiliate” is being defined, nor explanation of why such an exemption is prudent if the intent is to
 16 provide the Commission with authority over any transfer of an aggregate 10 percent of the economic
 17 interest. Further, Staff states, the language that exempts transfers to entities managed by the General
 18 Partner is vague, as the term “managed” is not defined, and again, there is no explanation why the
 19 exemption does not interfere with the intent to permit the Commission to approve transfers of
 20 economic interest.

21 Staff proposes the following in its stead:

22 Saguaro LP will not permit any ownership change among its
 23 limited partners without prior Commission approval if such change
 24 would result in any new limited partner(s) obtaining in aggregate
 more than 10% of the economic interests in Saguaro LP.
 (Attachment C, No. 13)

25 In response to Staff’s proposed language, UniSource states that the limited partners are each
 26 administered by an entity affiliated with its respective sponsor. Thus, UniSource does not anticipate
 27

28 ² At the hearing, UniSource agreed to modify the language originally proposed that is set forth in Exhibit B.

1 that prior Commission approval would be required when a limited partner merely transfers some or
 2 all of its interest in Saguaro LP from one of its affiliated interests to another, as it would not result in
 3 a new person or entity making decisions on behalf of the limited partner. In light of Staff's
 4 concerns, in its Reply Brief UniSource proposed the following to clarify the intent of Condition No.
 5 13:

6 Saguaro LP will not permit any change in the ownership of its
 7 limited partnership interests without prior Commission approval,
 8 except:

9 (a) changes which would not result in any new limited partner(s)
 10 obtaining in the aggregate more than 10% of all such limited
 11 partnership interests in Saguaro LP, or

12 (b) changes which result from a transfer by a limited partner to
 13 any affiliated entity whose investment and management decisions
 14 ultimately are made by the same entity or persons which control
 15 the existing limited partners of Saguaro LP.³

16 Condition No. 15- Commitments Regarding Community Support

17 UniSource's Condition No. 15 provides:

18 Saguaro LP, Saguaro Holdings, UniSource Energy and their utility
 19 subsidiaries shall continue to support and, where appropriate,
 20 enhance charitable and community corporate "giving programs,"
 21 education, environmental, economic and philanthropic partnerships
 22 and consumer partnerships at funding levels, in the aggregate equal
 23 to or greater than the amounts expended from September 1, 2003
 24 through August 31, 2004. (Attachment B No. 15)

25 Staff recommends additional language (in bold):

26 Saguaro LP, Saguaro Holdings, UniSource Energy and their utility
 27 subsidiaries shall continue to support (**in not only monetary
 28 contributions, but also non-cash resources made available at
 corporate direction and corporate support of employee
 community involvement**) and, where appropriate, enhance
 charitable and community corporate "giving programs," education,
 environmental, economic and philanthropic partnerships and
 consumer partnerships at funding levels, in the aggregate equal to
 or greater than the amounts expended from September 1, 2003
 through August 31, 2004. (Attachment C, No. 15)

29 Staff believes that its recommended addition clarifies that the Applicant's commitment
 30 extends to all the types of community support that UniSource currently provides. UniSource agreed

31 ³ Because UniSource made this proposal in its Reply Brief, Staff has not had an opportunity to respond to the proposal.

1 to Staff's proposed language, as it claims that it has always been UniSource's intent that this
2 condition apply both to monetary and non-cash resources.

3
4 Standard of Review

5 Staff states that the Arizona Constitution vests the Commission with a duty to consider and act
6 in the interest of the public. Article 15 § 3 of the Constitution gives the Commission the power "to
7 make and enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety,
8 and the preservation of the health, of the employees and patrons of [public service corporations]."

9 Staff asserts the Commission must not only consider, but act, in the public interest. *James P. Paul*
10 *Water Co. v Arizona Corporation Commission*, 137 Ariz. 426, 429, 671 P.2d 404, 407 (1983) and
11 *Arizona Corporation Commission v. Woods*, 171 Ariz. 286, 296, 830 P.2d 807, 818 (1992). Further,
12 determining the public interest involves a broad consideration of all the evidence presented. *Pueblo*
13 *Del Sol Water Co. v. Arizona Corporation Commission*, 160 Ariz. 285, 286, 772 P.2d 1138, 1139
14 (App. 1989).

15 Staff asserts that as part of its public interest analysis, the Commission may appropriately
16 consider all applicable statutes and rules, which in the matter at hand includes A.A.C. R14-2-803 of
17 the Affiliated Interest Rules. Staff argues, however, that this Rule does not limit the Commission's
18 review to the three listed factors in subsection (C). Staff suggests that an appropriate view of the
19 Rule is one that considers the language set forth in subsection (C) as examples of when this type of
20 transaction can be found to be not in the public interest.

21 Considering the great deference courts have granted the Commission pursuant to its
22 ratemaking authority, coupled with clear authority over "Affiliated Interest" matters, Staff argues the
23 Commission must be free to act in the furtherance of its constitutional duty. Staff argues it would be
24 counter to that duty for the Commission to construct a rule that would act to obstruct the broad
25 constitutional duty to take any action necessary in the furtherance of proper ratemaking. Thus, Staff
26 advances, Rule 803(C) must be interpreted consistent with the Constitution, and to interpret Rule
27 803(C) as a limit on the review of the public interest would obstruct the Commission's constitutional
28 duty. Staff questions whether an interpretation of Rule 803(C) that would limit the "public interest"

1 to the three areas spelled out would render the Commission powerless to protect against a merger that
2 could potentially harm the health or safety of Arizonans if the harm was not directly tied to the
3 regulated utilities' provision of service. Staff asserts Rule 803 is designed to highlight particularly
4 problematic areas that the Commission should include in its consideration of the public interest.

5 Staff further notes that in Decision No. 56844 (March 14, 1990), the Decision adopting the
6 Affiliated Interest Rules, the Commission made no indication that these rules were intended to
7 supercede or replace the Commission's constitutional charge. Decision No. 56844 states the
8 Affiliated Interest Rules are "designed to insure that utility ratepayers are insulated from the dangers
9 proven to be inherent in holding structure and diversification." (Attachment B, at 2) The Decision
10 provides that the Rules' purpose is to provide specific additional protections to ratepayers, which
11 demonstrate the Commission's intent that they enhance, rather than limit, the public interest analysis.

12 Staff submits that without conditions, the Application clearly fails AAC R14-2-803(C) and is
13 not in the public interest. Staff believes its proposed conditions, as set forth in Exhibit C attached
14 hereto, are necessary to mitigate potential detriments from the proposed Merger. Even with its
15 recommended conditions, Staff was unable to identify any benefits to consumers from the proposed
16 Merger.

17 Staff states that benefits are not inherent requirements for finding a transaction in the public
18 interest, but that in this matter there are so many potential risks and unknowns, that without benefits it
19 is difficult for Staff to state that the matter is in the public interest. Even with the adoption of all of
20 Staff's recommended conditions, in the absence of benefits to customers, Staff is neutral regarding
21 approval of the transaction.

22 RUCO

23 RUCO recommends that the Commission reject the proposed Merger on the grounds that the
24 ratepayers realize no incremental benefits to offset the additional risks inherent in the proposal.
25 RUCO asserts that the Commission should analyze whether to approve the transaction under both
26 the "non harm" standard of Rule 803(C) and the "public interest" standard. It is RUCO's position
27 that the proposed merger does not meet either standard.

28 RUCO states that Rule 803(C) gives little guidance to the Commission. According to

1 RUCO, the Rule is discretionary, providing that the Commission may either reject or approve a
2 merger if the Commission makes certain determinations. Under the Company's position, RUCO
3 argues, the Commission could approve a merger even if it is not in the public interest. The "public
4 interest" RUCO asserts, is a broad standard which considers many, if not all of the policy and legal
5 ramifications of a given transaction. In the Southwest Gas/ Black Mountain Gas merger (Docket
6 No. G-01551A-02-0425), RUCO notes the Commission found the public interest "includes the
7 safety and adequacy certainly, but also involves the impact of disparate rates, the reasonableness of
8 rates, the impact of Commission policy on utility operations in the state, advancement of
9 Commission policy goals and legal precedent, as well as other factors." Decision No. 66101 (July
10 25, 2003) at 13. Rule 803, RUCO argues, does not preclude analysis based on the public interest
11 standard, and if anything, falls within the public interest standard. RUCO argues that UniSource has
12 taken a rule that is clearly discretionary in intent and flipped its meaning to suggest that the
13 Commission is duty-bound to approve the merger if the conditions are met.

14 RUCO refutes that the Company-touted benefits of the proposed Merger – the cash infusion
15 of \$263 million, improving TEP's debt to equity ratios to 60/40, retaining present management post-
16 merger, and financially strengthening the three utility subsidiaries -- will enhance the utilities' ability
17 to provide service. RUCO believes these claims are misleading since the claimed benefits have
18 already been achieved or will be achieved absent the proposed Merger.

19 RUCO believes that TEP's current capital structure is acceptable for a regulated utility.
20 (RUCO -1 at 11) RUCO states that TEP's debt/equity ratio has significantly improved over the past
21 ten years and the Company has stated it has strong cash flows to cover its debts. (TR at 963, 966)
22 According to RUCO, TEP would likely achieve a 40 percent equity ratio on its own in the next three
23 to seven years. Moreover, RUCO argues, if the proposed Merger is approved, even with the
24 improved capital structure, there would be more pressure on TEP to generate income to meet the
25 debt service of its parent company. RUCO argues that the companies' liquidity would not improve
26 post-merger, as even now the companies have access to lines of credit. RUCO further asserts that
27 there is no reason to believe that TEP's current management, or the headquarters location, would
28 change absent the proposed Merger.

1 RUCO also argues that the proposed Merger exposes ratepayers to an unacceptable level of
2 risk and is therefore not in the public interest. RUCO argues the proposed transaction would
3 increase the risk of loss of an experienced and capable management team; result in additional debt
4 leverage; place increased constraints and commitments on current earnings; increase the risk of
5 eventual sale; and result in an unprecedented financial and structural form for a regulated utility.

6 RUCO states that current management holds a personal stake in the Company via their stock
7 ownership. Under the proposed Merger, RUCO argues, management's ownership would be
8 liquidated and they would become mere employees. At the time of the hearing, RUCO noted there
9 were no contracts with current management that would have management remain in their current
10 positions. RUCO argues that with no agreements that current management will remain, coupled
11 with the fact the new owners have no practical expertise in the regulated electric utility business, the
12 risk of operational and financial degradation post-Merger is increased.

13 In addition, RUCO asserts the capital structure of UniSource would increase from 72 percent
14 debt to 75 percent debt. RUCO believes the increased debt leverage introduces an increased level of
15 risk at the holding company, to which rating companies would react negatively. (RUCO – 1 at 14)
16 RUCO argues that the strengthening of the TEP capital structure comes at the cost of weakening the
17 financial integrity of UniSource as a whole.

18 RUCO also argues the proposed Merger would put increased pressure on the regulated
19 subsidiaries' earnings. RUCO states that 90 percent of UniSource's earnings are generated by TEP.
20 According to RUCO, it appears that 100 percent of TEP's annual earnings will be required to service
21 Saguaro Holding's debt. (RUCO –1 at 15) RUCO states that in the past five years, TEP's average
22 annual net earnings were approximately \$60 million. Saguaro Holding's \$660 million in debt
23 initially will carry a variable interest rate, currently 7 percent. RUCO states that after taxes,
24 approximately \$30 million of the \$60 million in earnings would be required to make the annual
25 interest payments, leaving \$30 million for debt principal. RUCO argues the constraint on cash flow
26 would put at risk the Company's ability to service its debt, and an increase in interest rates, decline
27 in sales or an increase in operating expenses would jeopardize the viability of the merged company.
28 (RUCO-1 at 16) Furthermore, RUCO cautions, the possibility that TEP's rates may be lowered as a

1 result of the rate review it filed on June 1, 2004, as required by Decision No. 62103, would further
2 jeopardize the merged company's ability to service its debt given its reliance on TEP to generate
3 earnings.

4 RUCO believes that the high purchase price being paid by the Investors places unnecessary
5 pressure on the regulated utilities to ensure profitability from the eventual sale of the Company.
6 RUCO says that the Investors would be paying approximately 68 percent over book value for
7 UniSource, thus, their ability to turn a profit would depend on their ability to pay down debt. RUCO
8 notes that although the Investors have agreed not to seek recovery of the premium, there is no
9 guarantee a new owner would agree to waive recovery of the premium. RUCO believes that the
10 Investors' goal to profit from the deal puts future ratepayers at increased risk of higher rates.

11 Finally, RUCO asserts there is no precedent in Arizona for the leveraged buyout of a public
12 utility. RUCO argues that the very nature of a leveraged buyout structure introduces an increased
13 level of risk. RUCO asserts this may be acceptable in an unregulated environment, where the only
14 parties that may be harmed are investors, but with a public utility, there is no viable substitute for
15 electric or gas service. RUCO argues the loss of this company would jeopardize lives as well as
16 local economies. Thus, RUCO argues the threshold for an acceptable level of risk for a public utility
17 is much lower than it would be for a competitive firm.

18 RUCO argues that the ratepayers' interest in receiving adequate electric service outweighs
19 the shareholders' right to an excessive return on their investment. RUCO believes that the proposed
20 Merger exposes ratepayers to increased risk to which they would not otherwise be exposed. RUCO
21 states that a wrong decision would result in the interruption or possible failure to provide a vital
22 service to ratepayers. By comparison, RUCO states, the shareholders' interest is exclusively
23 financial. RUCO asserts that while it is the role of the Commission to allow an opportunity for
24 stockholders to earn a fair return on their investment, it is not the duty or obligation of the
25 Commission to assure an excessive return on their investment. RUCO asserts that in the absence of
26 Commission approval of the proposed Merger, stockholders and speculators would be harmed only
27 to the degree their expected windfall profit is reduced. In RUCO's view, ratepayers have more to
28 lose than speculators and stockholders, and to add further insult, ratepayers would stand to gain

1 nothing incrementally for the additional risk.

2 RUCO believes that there is nothing in connection with the proposed Merger that would
3 change the Commission's authority post-merger, but RUCO joins with Staff's concern that the
4 Commission may face difficulty enforcing its authority post-merger. RUCO envisions that it may be
5 difficult for the Commission to obtain information in the future given the Investors' reluctance to
6 provide information that they consider proprietary in this proceeding.

7 RUCO believes that Staff's 20 conditions are not necessary as RUCO believes that the law
8 provides adequate protections. But, RUCO believes that the discussion is academic because even if
9 the Company agrees to all of Staff's conditions, Staff does not recommend approving the proposed
10 Merger. Because there are no additional price or quality-of service benefits, RUCO asserts the
11 proposed Merger is not in the public interest. (TR at 1090-91) RUCO states that it is not suggesting
12 that there are no conditions which would address its concerns, only that there is nothing in the record
13 that sufficiently addresses these concerns.

14 Mohave County

15 Mohave County intervened in this proceeding because it believed that the outcome could
16 affect UniSource's performance under the Settlement Agreement approved in Decision No. 66028.
17 Decision No. 66028, among other things, required UniSource to seek restructuring of the Power
18 Supply Agreement with Pinnacle West Capital Corporation in order to reduce rates to rate paying
19 customers. Mohave County states that either of the positions taken by Staff or RUCO are
20 protective of Mohave County's interests in this matter.

21 Mohave County notes that although referred to as the "no harm" rule, A.A.C. R14-2-8-3(C),
22 does not use the word "harm", but rather refers to "impair" or "prevent", as in the impairment of
23 financial status or prevention from attracting capital at fair and reasonable terms. According to
24 Mohave County, the terms "impair" and "prevent" have a broader meaning than simply "harm",
25 although they include that notion. Thus, Mohave asserts that the Commission defined the standard
26 in the Rule so as to balance the transaction equation among the owners and ratepayers.

27 Intervenor Marshall Magruder

28 Mr. Magruder provided his analysis of the benefits and costs to the various stakeholders in

1 this transaction. He concluded, among other things, that the proposed transaction is unfair to UNS
2 Electric and UNS Gas, as TEP is getting the greatest benefit from the transaction, but all three
3 entities would be up-streaming dividends to pay for the debt at the parent level. (Magruder Brief at
4 4)

5 Mr. Magruder also notes that the transaction will result in significant financial gains for
6 UniSource's current management. As shareholders, they benefited from the 25 percent increase in
7 the value of their stock just after the announcement of the proposed Merger, and would further
8 benefit because they held options that increased in value and would be liquidated at closing. In
9 addition, he says they voted a bonus upon closing. Finally, Mr. Magruder notes upper management
10 would receive five-year guaranteed employment packages and may receive stock in the new
11 organization.

12 In viewing the structure of the partnership, Mr. Magruder states that all voting power is
13 vested in the General Partner who would select various members of the boards of directors. While
14 the General Partner controls the organization, according to Mr. Magruder, he risks only his 1 percent
15 investment. As the General Partner has been a friend of a KKR principal for many years, Mr.
16 Magruder questions whether the personal relationship, rather than business reasons were important
17 to the selection of the General Partner. Mr. Magruder is concerned that the investors would seek to
18 increase their return on this investment by cutting costs that would adversely affect employees and
19 quality of service. Mr. Magruder argues that the only benefit the Investors bring to UniSource and
20 its subsidiaries is a lower cost of debt, which Mr. Magruder believes does not outweigh the risks in
21 the transaction. (Magruder Brief at 6) Mr. Magruder further believes that the risks of the transaction
22 are increased as a result of the General Partner and Limited Partners who are unfamiliar with the
23 business environment consisting of the changing electric industry which includes deregulation,
24 competition, shifts from central to distributed generation, information technology upgrades and
25 terrorism threats. Furthermore, he believes the overlapping boards may not optimize the
26 performance of the individual utilities, as the directors may strive to optimize the return for investors
27 at the expense of company operations and the effect on ratepayers.

28 In addition, Mr. Magruder foresees that the proposed transaction could make it more difficult

1 for the Commission to obtain information from investors, particularly if multi-state utility holding
 2 companies will be permitted in the future with the repeal of the Public Utility Company Holding Act
 3 (“PUHCA”). Mr. Magruder sees multi-state holding companies as a threat to the jurisdiction,
 4 authority and responsibilities of the Commission.

5 Finally, Mr. Magruder believes that the conditions that have been proposed in this transaction
 6 have been developed to address “loopholes” in the transaction as proposed. He fears, however, that
 7 they may not be sufficient to address unforeseen circumstances. In particular, Mr. Magruder
 8 questions whether there should be a condition that requires UNS Electric and UNS Gas to also
 9 achieve a 40 percent equity ratio.⁴

10 **Intervenor Lawrence V. Robertson**

11 Mr. Robertson would support the transaction if it is determined that UniSource can fully
 12 satisfy each of the conditions recommended by Staff.

13 **IBEW Locals 387 and 769**

14 IBEW Locals 387 and 769 support the proposed transaction because they believe the
 15 reorganization will have an overall positive effect on the community and business.

16 IBEW Locals 387 and 769 respectfully disagree with the Company’s analysis that the
 17 Commission can reject the transaction ONLY if: (1) it would impair the financial status of the public
 18 utility; (2) otherwise prevent it from attracting capital at fair and reasonable rates; or (3) impair the
 19 ability of the public utility to provide safe, reasonable and adequate service. IBEW Locals 387 and
 20 769 assert that nothing in the language or history of the code suggests that three factors are an
 21 exhaustive list of what the Commission may consider. IBEW Locals 387 and 769 argue the Arizona
 22 Constitution is a clearer and more viable source in determining the Commission’s realm of
 23 discretion. The Constitution, the IBEW Locals 387 ad 769 argue, “is the fundamental act of
 24 legislation by the people, embodying the principles upon which the government is founded,
 25 regulating the division of the sovereign powers, and directing to what persons each of these powers
 26 is to be confided and the manner in which it is to be exercised.” *Marbury v. Madison*, 5 U.S. 137,

27 _____
 28 ⁴ Condition 1(c) requires that TEP maintain a minimum 40 percent equity level without prior Commission approval. See Exhibit B.

1 176-78 (1803). See IBEW Brief at 6. The IBEW argues that by citing the Administrative Code as
2 governing authority, UniSource is sidestepping the Arizona Constitution. Article 15, section 3
3 provides “[t]he corporation commission shall have full power to . . . make and enforce reasonable
4 rules, regulations and orders for the convenience, comfort and safety, and the preservation of the
5 health, of the employees and patrons of such corporations.” It is explicit that the interests of the
6 Company’s employees are an important ingredient in the Commission’s duty to consider the public
7 interest. The IBEW Locals 387 and 769 argue that the administrative code does not take into
8 account the interests of the employees, and cannot be the complete analysis.

9 Analysis and Resolution

10 Although Rule 803(C) establishes a minimum standard for Commission consideration of
11 affiliate transactions, it is not the only applicable standard of review. The Commission has a
12 constitutional duty to make and enforce reasonable rules, regulations and orders to protect the
13 convenience, comfort, safety and health of employees and patrons of public service corporations.
14 Ariz. Const. Art. 15 § 3. The Commission must act in the “public interest.” *James P. Paul Water*
15 *Co. v. Arizona Corporation Commission*, 137 Ariz. 426, 429, 671 P.2d 404, 407 (1983). The inquiry
16 into the “public interest” is broad and the Commission should examine all the evidence available in
17 determining what is in the public interest. See *Pueblo Del Sol Water*, 160 Ariz. at 286.

18 The factors set forth in Rule 803(C), the so-called “No Harm” Rule, express the areas that are
19 of usual concern when evaluating transactions regarding the holding company structure. Rule 803(C)
20 employs the permissive “may” to evaluate when rejection of a proposed transaction is appropriate.
21 The use of the term “may” suggests that the Commission has broader discretion to consider factors
22 other than those expressed in the Rule – i.e., impairment of financial status, ability to attract capital at
23 fair and reasonable terms or the ability to provide safe, reasonable and adequate service. Although
24 the purpose of Rule 803(C) may be, as UniSource argues, to protect ratepayers from having to pay
25 higher rates, it is clear that the Commission has a broader duty to consumers, employees and the
26 public than to merely protect against higher rates. The Commission’s duty extends to quality of
27 service and safety. Indeed, the Commission has found that the Affiliated Interest Rules should be
28 applied to maximize protection to ratepayers. Decision No. 65453 at 18. The duty to act in the

1 public interest requires this Commission to consider all factors implicated in this transaction and not
2 solely the impairment of the financial status or services of the public service corporations. A careful
3 analysis of potential risks is particularly crucial when the proposed transaction can impact the public
4 health and safety.

5 The individual circumstances of each case influence the scope and breadth of the “public
6 interest” inquiry. In some cases, the guidelines of R14-2-803(C) may comprise the entire analysis of
7 whether a proposal is in the public interest. In other cases, circumstances may dictate that the
8 analysis of the “public interest” go beyond the specific language of Rule 803(C). The case before us,
9 a proposed sale of a publicly traded public utility holding company to a group of private investors by
10 means of a leveraged buyout, is, as far as we can tell, a case of first impression in Arizona. Its
11 uniqueness and the potential ramifications of the transaction require close and careful scrutiny. In
12 addition, this particular case requires an analysis from an historical perspective.

13 In the early 1990s TEP flirted with bankruptcy as a result of mismanagement and self-serving
14 deals by its former management.⁵ In the early 1980s TEP was building generation plant before it
15 needed the power to serve its native load, and used its excess capacity to serve the California market.
16 TEP formed a subsidiary, Alamito Company (“Alamito”), to market the excess capacity.
17 Springerville Unit No. 1, with a generating capacity of 360 MW, and San Juan Unit No. 3, with a
18 generating capacity of 244 MW, were both transferred to Alamito. TEP and Alamito entered into a
19 Power Sale Agreement (“PSA”) whereby TEP agreed to purchase Alamito’s entire output for twelve
20 years. The terms of the PSA were one-sided in favor of Alamito. Alamito was spun-off and sold to
21 Catalyst Energy Corporation in June 1986 in a leveraged buyout at a sales price of \$232 million
22 above its book value. TEP continued to pay an inflated price for power under the PSA. In October
23 1986, TEP and Alamito entered into an Amended PSA which terminated the requirement for TEP to
24 purchase power from the San Juan Unit, and extended the requirement to purchase power from the
25 Springerville Unit No. 1 through the year 2014. The Amended PSA also provided for the recovery of
26 the additional costs associated with the sale and leaseback of Springerville Unit No. 1 at a price that

27 _____
28 ⁵ See generally Commission Decision Nos. 58024 (September 16, 1992); 59543 (February 22, 1996); and 60480
(November 25, 1997).

1 exceeded the depreciated original cost by \$220 million, which meant TEP was paying lease payments
2 based on the inflated sale of the Springerville Unit No. 1. Until mid-1989, TEP had a contract with
3 San Diego Gas and Electric (“SDG&E”) and was able to pass on the inflated power costs. However,
4 when the SDG&E contract expired in May 1989, TEP was left with an obligation to purchase power
5 at a price well above what it could resell it for on the open market. At the same time, TEP’s
6 investments into non-utility businesses such as car leasing, real estate, security investments, hotels
7 and motels began to sour.⁶

8 In 1989, TEP filed for an \$80 million rate increase, but due to disallowances associated with
9 the imprudence of the Alamito spin-off, in Decision No. 56659 (October 24, 1989), the Commission
10 approved only a \$43 million revenue increase. It was not long before TEP could not meet on-going
11 obligations, and in January 1991, it instituted a payment moratorium. As a result, in July 1991, a
12 group of owner participants in the sale and lease back transactions filed Involuntary Petitions for the
13 Reorganization of TEP under Chapter 11 of the U. S. Bankruptcy Code. Meanwhile, in September
14 1990, TEP filed another application for a rate increase. On October 11, 1991, in Decision No. 57586,
15 the Commission approved an interim rate increase of \$71 million subject to resolution of the
16 Involuntary Bankruptcy Petitions. TEP was able to negotiate a reorganization plan with its creditors
17 that resulted in the dismissal of the Involuntary Petitions on December 31, 1991. On the same date,
18 the Commission made the rates permanent. In April 1992, TEP filed the reorganization plan with the
19 Commission for approval. The plan was approved by TEP shareholders and by the Commission in
20 Decision No. 58024 (September 16, 1992).

21 In January 1994, in Decision No. 58497, the Commission approved an increase in TEP’s
22 operating revenues of approximately \$21.6 million. At the time, TEP’s capital structure was
23 completely debt financed. However, the Commission determined that it was in the public interest to
24 utilize a hypothetical capital structure comprised of 44 percent equity for rate making purposes. In
25 TEP’s subsequent rate case, its financial condition had improved sufficiently to allow the
26 Commission to utilize a hypothetical capital structure for rate making purposes that consisted of 37.5

27 ⁶ We note that TEP’s transactions with Alamito and its investments in the non-energy related assets pre-dated the
28 enactment of the Commission’s Affiliated Interest Rules. Indeed, TEP’s disastrous experience served as an impetus for
the enactment of the Affiliated Interest Rules.

1 percent equity. See Decision No. 59594 (March 26, 1996). TEP's rates have been based on a
2 hypothetical capital structure, consisting of more equity than the company actually had, since the
3 early 1990s. The hypothetical capital structure allowed TEP to collect sufficient revenues from
4 ratepayers to recover from the brink of bankruptcy.

5 Given this historical perspective, it is incumbent upon the Commission in its public interest
6 analysis to make sure that the ratepayers' sacrifice is not minimized or exploited. Ratepayers had no
7 control over the behavior of prior management. Consequently, fairness dictates that ratepayers are
8 not only protected from harm, but also receive tangible benefits as result of this proposed sale.

9 As it is presently structured, we do not find the ratepayers receive a tangible benefit as a result
10 of the proposed Merger. We also find based on all the evidence, that the proposed reorganization, as
11 it is presently structured, is not in the public interest. The purported benefits claimed by the Merger's
12 proponents of an improved TEP capital structure; increased liquidity; a continued local community
13 presence; and retention of current management; are clearly not sufficient to outweigh the potential
14 detriments and risks of the transaction. The risks of increased leverage, and the detriments of the
15 partnership structure with a concentration of power in a general partner inexperienced in the public
16 utility sector, and uncertainties concerning Commission oversight over the new entities, outweigh the
17 claimed benefits.

18 Many of the benefits of the transaction to the community and the ratepayers touted by the
19 Company are overstated. The most significant benefit of the reorganization is the improvement to
20 TEP's capital structure and the expected improved access to credit markets. TEP ratepayers will not,
21 however, notice a benefit from this improved capitalization. They have been paying rates based on
22 an hypothetical capital structure that contained more equity than the Company actually had, for many
23 years. See Decisions Nos. 58497 (44 percent equity) and 59594 (37.5 percent equity).⁷ During that
24 time the cost of equity has been greater than the cost of debt. See Decision No. 58497. As a result,
25 ratepayers have paid higher rates. (TR at 1206) Although the Company testified that as a result of
26 the reorganization, it has received financing on better terms than it otherwise would, there is no
27

28 ⁷ Despite steady improvement to its equity position, TEP's current capital structure contains only 26 percent equity.

1 indication that absent the Merger, any of the entities, UniSource, TEP or UES, are unable, or will be
2 unable to access the capital markets. The marginal benefit of the access to capital markets
3 occasioned by the involvement of the Investors does not compensate for the added risks of the
4 reorganization. TEP's debt/equity ratio has been steadily improving and would probably reach the
5 60/40 debt/equity level in the next three to seven years. (RUCO-1 at 9) Staff's finance witness
6 testified that assuming the business risk remained constant, increasing TEP's common equity ratio to
7 40 percent with the \$263 million cash infusion has the same effect on its cost of equity as achieving a
8 40 percent equity ratio over a period of five years. (S-1 at 18) Staff estimates the effect of the
9 proposed transaction on TEP's cost of capital to be minimal, assuming TEP does not experience a
10 rating downgrade.⁸ While Staff would expect that both the cost of TEP's debt and equity would
11 decrease after the Merger, the increase in the proportion of equity in the capital structure will counter
12 the lower cost. (S-1 at 18) Staff testified that any change in TEP's authorized rate of return granted
13 in a rate proceeding would likely be unrelated to its capital structure. (Id.).

14 The Company also claims that the community would benefit from the Merger because the
15 UniSource and TEP headquarters will remain in Tucson, current senior management will remain, and
16 the Company will maintain its charitable giving commitments at least at current levels. The
17 assumption appears to be that if UniSource is sold to an entity other than the Investors, the corporate
18 headquarters may be moved, Mr. Pignatelli and his senior management team removed, and corporate
19 giving decisions will be made at a distance. While we recognize the benefits to the local
20 communities flowing from a local management team and corporate presence, the threat appears
21 academic as any future sale or merger involving UniSource or its affiliates would require
22 Commission approval. The Commission could, and would, consider the impact of any sale or merger
23 on the local community in considering whether such transaction is in the public interest. Although
24 there may be a benefit to retaining the current management team, we do not believe the Company's
25 improved financial condition is due entirely to the efforts of one or two individuals. We have

26 ⁸ There is no evidence that TEP's debt would be downgraded if the Merger is not approved. The bond ratings did not
27 change when the Merger was announced, except that Standard & Poor's placed TEP on credit watch with negative
28 implications. (S-1)

1 confidence that the Board of Directors would make every reasonable effort to maintain capable
2 management.

3 The Commission received voluminous comments from charities and municipalities attesting
4 to UniSource's generous funding and good corporate citizenship. The Company has been a generous
5 supporter of communities and charities even while it has been rebuilding its financial health, and we
6 commend the UniSource companies and their employees for their efforts. There is no reason to
7 believe, however, that the Company would suddenly curtail or cut its charitable giving programs in
8 the event the Merger does not materialize. We are confident and expect that UniSource and its
9 subsidiaries will continue to demonstrate community involvement.

10 Proponents further argue the ratepayers would receive a benefit as a result of the
11 reorganization because UniSource is committing TEP, UNS Gas and UNS Electric to spend at least
12 \$1.5 billion on Operations and Maintenance through 2008. UniSource believes that this is the amount
13 it will have to spend to maintain its quality of service for TEP and improve service quality at UES
14 over the next few years. (TR at 1054-5) This argument fails to recognize that the utilities already
15 have an obligation to provide reasonable and adequate service, and are obligated to make that level of
16 expenditures necessary to provide reasonable and adequate service. A commitment to make
17 expenditures that would have to be made in any event is not an added benefit to consumers resulting
18 from the Merger. In any event, UniSource has failed to establish the appropriate level of
19 expenditures under its duty as a public service company. Therefore, based on the record, we are
20 unable to determine if \$1.5 billion is reasonable and we concur with Staff that, at this point in time,
21 we cannot accurately evaluate the reasonableness of UniSource's commitment.

22 Neither is the record sufficiently developed to permit us to evaluate the reasonableness of
23 UniSource's lack of commitment to Staff's recommendation that the prepayment of debt and lease
24 obligations be increased from \$400 million to \$500 million through 2008. Staff believes its proposal
25 is a necessary component if the Commission were to approve the transaction. Without it, Staff does
26 not recommend approval. Even if it were adopted, we note Staff does not support the transaction. In
27 any case, we are unable to evaluate the reasonableness of UniSource's proposed reductions.

28

1 One of our major concerns about the proposed transaction is the limited partnership structure.
2 The Commission has the constitutional and statutory authority to examine, inspect and investigate the
3 books and records of public service corporations. The limited partnership structure is not as
4 conducive to the disclosure of information as a publicly traded corporate structure. As a publicly
5 traded corporation, UniSource is currently subject to broad disclosure requirements. As has been
6 demonstrated in the course of this proceeding, the Investors believe they can shield otherwise
7 relevant information from the Commission merely by keeping it at a level of the organization an
8 additional step above the public service corporation on the organization chart. We are concerned that
9 this structure will weaken and make more difficult the Commission's ability to exercise oversight
10 over UniSource and its subsidiaries. As has been demonstrated historically, and recognized in the
11 enactment of our Affiliated Interest Rules, the activities of non-utility affiliates can have a grave
12 impact on the public service corporations. Although as part of the conditions to the Merger, Saguario
13 LP, Saguario Holdings and UniSource have stated they agreed to provide full access to their records
14 on the same basis as provided by UniSource and its utility subsidiaries, doubt remains as to the
15 Commission's ability to access information it believes is relevant. (See Sept. 28, 2004 Proc. Conf TR
16 at 56) Staff and RUCO both encountered difficulty accessing materials that they believed would
17 have been relevant to their analysis of the transaction. (S-3 at 9; RUCO- 1 at 15) The Investors'
18 refusal to disclose certain materials does not give us confidence that the relationship between the
19 Commission and the Investors would enable the Commission to retain the same level of oversight
20 that currently exists, and which is a necessary and critical component of the Commission's
21 constitutional duty to protect the interests of both the Company and its ratepayers.

22 In addition, corporate governance is also weaker under the proposed restructuring than under
23 the current structure. Currently, UniSource has a board of directors consisting of 10 members. TEP
24 and UNS Electric and UNS Gas also have their own boards of directors. Under the proposed
25 structure, Saguario Holdings would have a board of directors of only two – Mr. Pignatelli and Mr.
26 Rentschler. (TR at 825) These two individuals would appoint the board for UniSource, although it
27 appears that the authority to appoint board members would ultimately fall to Mr. Rentschler. (TR at
28 828-29) The UniSource board would be reduced to four members, consisting of Mr. Pignatelli and

1 Mr. Rentschler and two others. The boards of TEP, UNS Gas and UNS Electric after the Merger
2 would consist of five members, and all of the utility company boards are expected to have identical
3 memberships. (TR at 872-74; TR at 1052-53) The reduction in the number of board members
4 restricts the breadth of opinions and experience that will formulate corporate policy. We do not view
5 the reduction in board members, especially given the power of the general partner, to be a benefit,
6 but rather to be a detriment in light of the size and state-wide presence of the UniSource organization.

7 While Mr. Rentschler, the general partner, appears to have experience managing several
8 large companies, he does not have a background in the public utility industry. Yet, under the
9 proposed plan he would have tremendous power over the governance of the public utilities. He has
10 expressed an intent to defer to Mr. Pignatelli on the day-to-day operations of the utilities, but it seems
11 clear that it is ultimately Mr. Rentschler who would be given the power (subject to significant
12 oversight by the limited partners) to control the governance of the Company. Although we believe
13 Mr. Pignatelli, with the aid of his management team, has overseen TEP's financial recovery, such
14 reliance on one individual in connection with a reduction in an experienced board of directors, is a
15 potential weakness of this transaction.

16 As described in Mr. Antonuk's testimony, the terms of the limited partnership agreement give
17 the limited partners significant control over details of the Company's operations. (S-3 at 75-88
18 **confidential**) The Investors may state an intent to defer to Mr. Pignatelli on the day-to-day
19 operations of the Company, but they retain substantial control over operations. We concur with Staff
20 that such control is unusual, and potentially cumbersome, especially with Investors with limited
21 experience with utility operations. (S-3 at 9) We do not believe that this structure, with so much
22 power in the limited partners who do not believe the Commission has oversight over them, and who
23 have expressed the belief they can prevent the disclosure of relevant financial information to the
24 Commission, is in the public interest. Staff's proposed Condition No. 13 addresses the issue of
25 changes in control of the limited partners, but it does not address the control of the existing limited
26 partners.

27 Staff believed that at a minimum, to approve the Merger, the Commission must require that
28 UniSource have lenders agree to insert language in their credit facilities that provides all Saguaro

1 Holding and UniSource debt will include separateness covenants. Staff believes that this condition is
2 critical, and recommends that if the Company is unable to negotiate such changes that the
3 Commission should only waive the requirement if ratepayers receive a comparable benefit for the
4 increased risk. We cannot predict whether lenders would agree to change existing credit agreements.
5 It would not be surprising, however, that if such a condition were imposed, the Company would soon
6 be back requesting a waiver of the requirement. In such a case, based on the current record, we can
7 not speculate about our ability to grant ratepayers a compensatory benefit for the added risk from not
8 having Staff's recommended protective language in the credit facilities.

9 Although it appears the possibility of bankruptcy would be remote if the reorganization is
10 approved, we must nevertheless consider the potential of such an occurrence. The record reflects that
11 all other things being equal, after the Merger the reorganized entity would have more debt than it has
12 currently. The proposed Merger would reduce TEP's debt, but the debt would merely be shifted to
13 the holding company. At least initially, TEP's earnings would continue to be the source of funds for
14 debt service. The acquisition debt is expected to be non-investment grade due to the high leverage.⁹
15 (S-1 at 8) Given that the cash flow for repayment of the debt comes from utility revenue, primarily
16 from TEP, the possibility exists that a reduction in revenues at the utility company level could have a
17 detrimental effect on the parent company. Increased leverage places pressure on the utility to
18 generate revenues which may lead to cutting expenses with resultant negative effects on service
19 quality or safety. This possibility, although remote, is yet an additional factor supporting our
20 determination that the application is not in the public interest.

21 Furthermore, even if utility assets were not directly pledged to secure the parent company
22 debt, we are concerned that in the event of a bankruptcy at the holding company level, a creditor or
23 other third party could gain control of UniSource stock. Given the broad power of a bankruptcy court
24 to approve a sale without liens, and potentially without other conditions, it is not certain that an entity
25 acquiring the stock in bankruptcy, and not a party to the current transaction, would be bound by the
26 "protecting" conditions the Investors have agreed to, or Staff has recommended, as part of this

28 ⁹ TEP debt is currently non-investment grade.

1 transaction.¹⁰

2 For the reasons set forth above, on balance, we believe the risks of the proposed transaction
3 outweigh the claimed benefits and we find that the proposed transaction is not in the public interest
4 and should be denied. Our conclusion is supported independently under our constitutional obligation
5 to act in the public interest as well as pursuant to the requirements of Rule 803(C), as we cannot find
6 that the reorganization would not impair the financial status of the public utilities and their ability to
7 provide safe, reasonable and adequate service.

8 **Issues Concerning Disclosure of Documents**

9 During the course of this proceeding an issue arose about whether UniSource would, or
10 could, produce documents which were prepared by the Investors as part of their analyses of the
11 transaction. In the course of Commissioner Mundell's questioning of Mr. Stuart, who was testifying
12 as part of a panel comprised of representatives of the Investors, mention was made of an analysis
13 performed on behalf of the Investors by the accounting firm Ernst & Young ("E&Y"). The E&Y
14 report was prepared for the benefit of the Investors as part of their due diligence review of the
15 Company. According to Mr. Stuart, one portion of the report supported the view that TEP was
16 under-earning. (TR at 675-76) When Commissioners Mundell and Mayes expressed an interest in
17 seeing the report, UniSource claimed that disclosure was not a decision it could make as it has never
18 seen the E&Y Report and does not have a copy of it in its possession. UniSource stated the E&Y
19 Report belonged to the Investors and the Investors reported back to UniSource that their contract
20 with E&Y prevented them from disclosing the report to third parties.

21 Following letters to the docket from Commissioners Mundell, Mayes and Spitzer, the
22 Commission convened a procedural conference on September 28, 2004, for the purpose of
23 discussing the discoverability of the E&Y report. Although UniSource does not believe the rate
24 review portions of the E&Y Report are relevant to the proceeding, in the event the Commission
25 found otherwise, it held discussions with the Investors and E&Y to determine whether the report
26 could be released under any terms. At the September 28, 2004, Procedural Conference, UniSource

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28

¹⁰ A voluntary sale of UniSource stock would have to be approved by the Commission. A.A.C. R14-2-803.

1 reported that E&Y agreed to make available, subject to a protective order, only the Executive
2 Summary of that portion of its due diligence report that addresses the earning issue available in this
3 proceeding.

4 Presumably this report supports the testimony that TEP is under-earning. (TR at 675) The
5 issue of whether TEP is over or under earning is certainly relevant to the Commission's analysis of
6 the proposed transaction. Although the Investors offered to provide access to a portion of the
7 Executive Summary, we are not convinced that the entire report is not discoverable. Pursuant to the
8 Affiliated Interest Rules, Public Holding Companies must make their books, records and other
9 documents available to the Commission to permit the Commission to investigate affiliate
10 transactions and determine if such transactions would impair the utility affiliates. No party has
11 provided a valid legal argument supporting why the entire report would not be subject to production
12 in response to a valid discovery request or pursuant to a Commission subpoena.

13 However, in view of our decision herein that the application is not in the public interest, and
14 is therefore denied, it is not necessary to require production of the E&Y Report at this time. Had the
15 record before us not been sufficient to make such conclusion, or had supported a finding that the
16 transaction may be in the public interest, we would require the E&Y Report in its entirety be
17 disclosed.

18 In addition to discussions concerning the disclosure of the E&Y report, Commissioners
19 Mundell and Mayes expressed an interest in internal rate of return ("IRR") studies the individual
20 Investors performed. The Investors claim these IRR reports contain extremely sensitive information
21 that they would not even disclose to each other, much less a third party, and they "cannot be
22 produced."¹¹ (Sept. 28, 2004 Proc. Conf. TR at 63) The Investors argue that in addition to the
23 highly proprietary content, disclosure would be inappropriate as the information is speculative
24 (being a year old and projecting what might occur in six to eight years); is cumulative to evidence
25 already in the record; and irrelevant to the issue of whether the standards of Rule 803(C) are met.
26 (Id. at 64-65) The Investors stated that they believe the testimony of Staff's witness Reiker on the

27 ¹¹ This refusal to turn over documents, even subject to a protective order, reinforces our concern that the Investors would
28 seek to shield from Commission oversight documents and information that the Commission and its Staff deem relevant
for purposes of ongoing regulation of UniSource and its affiliated public service companies.

1 issue of expected Investor returns was “a reasonable approach.”¹² (Id. at 64) Presumably, by
2 “reasonable approach” Mr. Stuart meant that the Commission should be assured that Mr. Reiker’s
3 estimate is in the range of expected returns as calculated by the Investors.

4 We have not concluded that the IRR studies are not discoverable in a proceeding such as this.
5 Arguably, under the Affiliated Interest Rules, the Investors, and not only Saguaro LP, Saguaro
6 Holdings, UniSource and Sage, can be considered a Public Utility Holding Company. A.A.C. R14-
7 2-801 defines a Holding Company as any “affiliate that controls a public utility.” An affiliate is
8 defined as “any other entity directly or indirectly controlling” the public utility. To “control” or be
9 “controlled by” means “the power to direct the management policies of such entity, whether through
10 ownership of voting securities, or by contract, or otherwise.” A.A.C. R14-2-801. The Limited
11 Partnership agreement gives the Investors control over some of the actions of the General Partner.
12 (S-3 at 75-77, **confidential**) Accordingly, the reservation of power in the Investors may bring them
13 under the definition of a Holding Company within the Affiliated Interest Rules. It is clear, however,
14 that the Investors themselves do not consider themselves parties in this proceeding, (See September
15 28, 2004 Proc. Conf. TR at 53), and it is likely the Investors would dispute a finding that they would
16 be found to be a Public Utility Holding Company. Whether they are a Public Utility Holding
17 Company under our rules, or not, the Investors play an undeniably critical role in the financing and
18 operations of the proposed reorganized UniSource entity. Their plans and assumptions for this
19 organization are highly relevant.

20 It appears that the IRR studies could contain information that might impact a determination
21 on whether the proposed transaction would affect the financial status of the utilities, including their
22 ability to attract capital and ability to provide safe, reasonable and adequate service. Rule 803(C).
23 Therefore, we believe the studies are relevant, and would be considered reasonably calculated to lead
24 to the discovery of admissible evidence.

25 In this case, we believe the record fully supports our decision to deny this application
26 whether or not the IRR studies or the E&Y Report are produced, and consequently, we will not order

27 _____
28 ¹² In a confidential portion of his testimony, Mr. Reiker estimated the compound annual return on the Investors initial
investment. (S-1 at 23 **confidential**)

1 their production at this time. We note, however, that if we did not believe the current record fully
2 supported our decision to deny the application, we would likely order the production of both the
3 E&Y Report and the IRR studies.

4 **Summary**

5 In Decision No. 58024, the Commission likened TEP’s financial collapse to the horse that had
6 escaped the barn:

7 In the 1980’s, TEP was like a feisty and strong horse galloping out
8 through the open barn door. For a while it thrived in the wide open
9 spaces. However, when the drought came, the horse came limping home
10 to its barn to be revitalized. Now the door is closed again and the only
11 question remaining is whether or not the horse can be saved. Clearly the
12 financial collapse of this once proud Company resulted from TEP’s
management imprudence and abuses of the 1980’s. The Commission
could simply deny the application in this matter which would force the
Company into bankruptcy or approve the application in hopes that the new
management of TEP can breathe new life into the struggling beast. (Dec.
No. 58024 at 22)

13 As detailed in Decision No. 58024, there was plenty of suffering to go around as a result of
14 TEP’s lack of prudence in the 1980s—creditors, shareholders and ratepayers all paid dearly for the
15 wild ride. Although TEP has been nursed back to health over the past decade due, in large part, to the
16 sacrifice of TEP ratepayers, we are being asked through this application to approve a scheme that has
17 relatively few benefits for the Company or its ratepayers compared to the risks associated with the
18 transaction. Although a merger proposal may be presented in the future that would satisfy our public
19 interest concerns, the proposed reorganization before us contains far too many risks and uncertainties
20 and far too few tangible benefits for the ratepayers and local communities to justify our approval.

21 Based on the evidence presented, neither UniSource nor its utility subsidiaries will be harmed
22 by denial of the reorganization. The evidence indicates they will continue to be able to attract capital
23 and their earnings will be sufficient to provide safe and reliable service. As discussed above, the
24 detriments of the increased leverage, the limited partnership structure, and the Commission’s
25 potentially weakened oversight capability, outweigh the benefits of the proposed reorganization to
26 such an extent that the reorganization is not in the public interest.

27 * * * * *

1 testimony of Marylee Diaz-Cortez and Staff filed the testimony of Joel Reiker and John Antonuk.

2 11. On May 25, 2004, UniSource filed the rebuttal testimony of Mr. Pignatelli and Scott
3 Stuart, a member of KKR.

4 12. On June 11, 2004, Staff filed the surrebuttal testimony of Mr. Antonuk and RUCO
5 filed the surrebuttal testimony of Ms. Diaz-Cortez.

6 13. The hearing convened as scheduled on June 21, 2004.

7 14. UniSource, RUCO, Staff, IBEW and AUIA filed Initial Briefs on July 30, 2004.
8 Mohave and Mr. Magruder docketed their Briefs on August 5, 2004. UniSource, AUIA, RUCO and
9 Staff filed Reply Briefs on August 16, 2004.

10 15. During the hearing the issue of the discoverability and disclosure of certain reports
11 commissioned or prepared by the Investors arose. Although the parties to the case did not pursue
12 Motions to Compel, two Commissioners who attended the hearing believed that the reports which
13 were mentioned in testimony might be relevant to their analysis of the proposed reorganization. By
14 Procedural Order dated September 24, 2004, a Procedural Conference convened on September 28,
15 2004, at the Commission's Phoenix offices for the purpose of discussing whether, and under what
16 terms, the subject reports could be made available to the Commission.

17 16. TEP is an Arizona public service corporation that provides electric generation,
18 transmission and distribution services to customers within portions of Pima and Cochise Counties,
19 Arizona. TEP's principal place of business is Tucson, Arizona. UES is the owner of all the issued
20 and outstanding common stock of UNS Gas and UNS Electric. UNS Gas is an Arizona public
21 service corporation that provides retail natural gas service to approximately 125,000 customers in
22 portions of Mohave, Yavapai, Coconino, Navajo, Greenlee and Apache Counties. The principal
23 place of business for UNS Gas is Flagstaff, Arizona. UNS Electric is a public service corporation
24 that provides retail electric service to approximately 77,500 customers in Mohave and Santa Cruz
25 Counties. UNS Electric's principal place of business is in Kingman, Arizona.

26 17. KKR is a private investment firm headquartered in New York, London and Menlo
27 Park, California. The primary investors in KKR affiliated investments funds are institutions,
28 including state and corporate pension funds, banks, insurance companies and university

1 endowments. After completion of the Merger, KKR affiliated investment funds would own
2 approximately 62 percent of the equity in Saguaro LP.

3 18. JPMP is an indirect, wholly-owned subsidiary of J.P. Morgan Chase & Co., one of
4 the largest financial entities in the United States. After completion of the Merger, investment funds
5 and other entities affiliated with JPMP would own approximately 31 percent of the equity in Saguaro
6 LP.

7 19. WCP is the principal investing group of Wachovia Corporation, the nation's fifth
8 largest financial holding company. After completion of the merger, investment funds affiliated with
9 WCP would own approximately 7 percent of the equity in Saguaro LP.

10 20. Sage is an Arizona limited liability company, owned and managed by Frederick B.
11 Rentschler, the former president and chief executive officer of Armour-Dial, Beatrice Companies
12 and Northwest Airlines. Mr. Rentschler is a resident of Maricopa County, Arizona.

13 21. Upon completion of the proposed Merger, Saguaro Acquisition Corp. would cease to
14 exist and UniSource would be the surviving entity. A copy of the organizational chart of the
15 proposed post-merger structure is attached as Exhibit A. Each outstanding share of UniSource's
16 common stock would be converted into the right to receive \$25.25, and Saguaro Holdings, a wholly-
17 owned subsidiary of Saguaro LP would become UniSource's sole shareholder. There would be no
18 change in ownership of UniSource's subsidiaries as a result of the merger.

19 22. After the proposed Merger, it is proposed that Saguaro Holdings have a Board of
20 Directors consisting of two members, Messrs. Pignatelli and Rentschler. UniSource would have a
21 Board of Directors comprised of four members, two of whom would be Messrs Pignatelli and
22 Rentschler, and two of whom would qualify as independent of UniSource, Saguaro Holdings,
23 Saguaro LP, any of Saguaro LP's partners and KKR, JPMP and WCP and entities they control.

24 23. TEP, UES, UNS Gas and UNS Electric would each have a Board of Directors
25 comprised of at least five members, at least two of whom would be Arizona residents and two of
26 whom would be independent.

27 24. At the closing of the proposed Merger, the limited partners of Saguaro LP would
28 provide aggregate capital contributions to the partnership of up to \$555.7 million, and the general

1 partner would provide a capital contribution of approximately \$1 million. Saguario LP would
2 provide Saguario Holdings with an equity contribution of up to \$556.7 million. In addition, Saguario
3 Holdings would borrow up to \$660 million, which would fund the cash purchase price, fund the cash
4 infusion to TEP and pay transaction expenses. The borrowing would include up to \$360 million in
5 senior secured bank loans and up to \$300 million in debt securities at closing.

6 25. Saguario Holdings would provide a capital contribution of approximately \$1.2 billion
7 to Saguario Acquisition/UniSource (\$556.7 million in equity contribution and \$660 million in
8 borrowing). Approximately \$880 million of such funds would be paid to UniSource's existing stock
9 and option holders and up to \$263 million would be used to improve TEP's debt/equity ratio to
10 60/40.

11 26. After closing TEP would have available a \$60 million revolving credit facility, UES
12 would have available a \$40 million revolving credit facility and a \$50 million revolving credit
13 facility would be available to Saguario Holdings and UniSource.

14 27. The parties to the proposed Merger also agreed that TEP's and UniSource's
15 management and corporate headquarters would remain in Tucson and that TEP, UNS Gas and UNS
16 Electric would not guarantee the obligations of UniSource.

17 28. In addition to its initial proposal, after receiving the comments of Staff and RUCO in
18 their direct testimony, UniSource presented additional conditions to the proposed transaction that it
19 believed would address the concerns of Staff and RUCO. The commitments and conditions that
20 UniSource has agreed to as part of the proposed Merger are set forth in Exhibit B, attached hereto
21 and incorporated herein. The proposed conditions include terms intended to safeguard the financial
22 integrity of the utilities, often referred to as ring-fencing; service quality and reliability; relationships
23 between affiliates; corporate governance, oversight and community presence; and the non-
24 recoverability of merger and affiliate costs.

25 29. AUIA, and the IBEW Locals Nos. 387 and 769 support the transaction as it is
26 proposed by UniSource and the Investors, although IBEW Locals 387 and 769 disagreed with the
27 Company's analysis of the standard that should be applied for evaluating the transaction.

28 30. UniSource and the Investors claimed that the proposed reorganization would produce

1 the following benefits: TEP would receive an immediate infusion of \$263 million, which would be
2 used to pay down TEP debt and improve TEP's debt/equity ratio from 25 percent equity to 40
3 percent equity; TEP, UNS Gas and UNS Electric would benefit from increased liquidity as a result
4 of new credit facilities and the utilities would be able to attract capital at better terms than before;
5 UniSource and its utility affiliates would continue to be locally managed and headquartered;
6 UniSource's utility affiliates would spend at least \$1.5 billion in operating and maintenance
7 expenses and capital expenditures for the years 2005-2008; TEP would make at least \$400 million
8 of voluntary debt and lease prepayments and buybacks prior to December 31, 2008; and
9 shareholders would receive fair value for their shares. The utility affiliates have agreed not to seek
10 recovery in any future rate case of the costs of the Investors before or after the Merger and from the
11 Investors' agreement not to seek recovery of any acquisition premium.

12 31. AUIA concurs with UniSource's assessment of the benefits of the transaction and
13 argues its approval would be a signal to the markets that Arizona is an attractive place to invest.

14 32. IBEW Locals Nos. 387 and 769 believe that the proposed transaction would have an
15 overall positive effect on the utilities' communities and local business.

16 33. As proposed by UniSource and the Investors, the transaction is opposed by Staff,
17 RUCO, Mohave County and Mr. Magruder.

18 34. Staff believes that even with the additional proposed conditions, the transaction
19 contains unacceptable risks. Staff proposed a set of conditions to strengthen those proposed by the
20 Company in an attempt to reduce the risks. Staff's proposed conditions are set forth in Exhibit C
21 hereto, and incorporated herein by reference. However, even if the Commission were to adopt all of
22 Staff's recommended conditions, Staff is neutral on whether the Commission should approve the
23 transaction because Staff does not believe there are immediate benefits accruing to ratepayers under
24 the proposed restructuring.

25 35. The Commission received an unprecedented large amount of public comment in
26 connection with this proposed transaction, the vast majority of which was from charities and
27 municipalities which praised TEP's and UniSource's generous support of their missions and
28 communities. These entities supported the proposed reorganization as they believed it to be very

1 important that UniSource maintain its level of community support by keeping its headquarters in
2 Tucson and continuing local control over charitable giving decisions. During public comment most
3 of the opposition to the transaction was expressed by individual ratepayers who did not see the
4 benefits of the transaction as real.

5 36. RUCO opposed the transaction because it found no benefits for ratepayers to offset
6 the added risk of the increased leverage.

7 37. Mohave County concurred with Staff and RUCO and believed the proposed
8 transaction could hinder UniSource's ability to renegotiate its Power Supply Agreement with
9 Pinnacle West with a goal of lowering rates.

10 38. Mr. Magruder opposed the transaction because he did not find any benefits flowing to
11 UNS Gas or UNS Electric.

12 39. In the 1980s, TEP suffered from mismanagement that caused its creditors to file
13 Involuntary Petitions for the reorganization of TEP under Chapter 11 of the Bankruptcy Code in
14 1991. In Decision No. 58497 (January 13, 1994) the Commission approved a hypothetical capital
15 structure consisting of 44 percent equity. At that time, TEP's actual capital structure consisted of
16 100 percent debt. In Decision No. 59594 (March 26, 1996) the Commission approved a hypothetical
17 capital structure for rate making purposes that consisted of 37.5 percent equity. TEP's current
18 capital structure consists of approximately 75 percent debt and 25 percent equity.¹³ Since the early
19 1990s TEP's rates have been determined using a hypothetical capital structure that included more
20 equity than TEP actually possessed. During the relevant period, the cost of equity has been higher
21 than the cost of debt, and TEP ratepayers have been paying higher rates than they would otherwise
22 have paid if rates were based on TEP's actual capital structure.

23 40. Ratepayers would not see any tangible benefits as a result of TEP's increased equity
24 resulting from the proposed Merger as they have been paying rates based on a hypothetical capital
25 structure very close to the post-merger capital structure and because any improvement in the cost of
26 debt and equity as a result of the Merger would be countered by the increased proportion of the more

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28 ¹³ These figures have excluded capital lease obligations for ratemaking purposes. TEP's current capital structure is approximately 83 percent debt and 17 percent equity when capital leases are included.

1 expensive equity component.

2 41. It is expected that TEP would achieve a 60/40 debt/equity ratio within five to seven
3 years in the absence of the proposed Merger.

4 42. There was no evidence presented that either UniSource or the utility subsidiaries are
5 currently unable, or would be unable absent the Merger, to attract capital for liquidity needs or
6 capital investments.

7 43. UniSource has failed to establish a benchmark to allow the Commission to evaluate
8 the reasonableness of UniSource's commitment to spend \$1.5 billion through 2008 to maintain
9 TEPs's service quality and improve the service quality of the UES utilities.

10 44. There was no evidence to indicate that absent the proposed Merger, TEP would be
11 acquired by another entity or its headquarters would be relocated.

12 45. The proposed reorganization increases the consolidated leverage, and consequently
13 the risk associated with the proposed reorganized Public Utility Holding Company.

14 46. The Investors have limited experience operating the regulated public utility sector.
15 The General Partner has no prior experience in the public utility sectors.

16 47. The proposed limited partner structure gives the limited partners the ability to oversee
17 and restrict the General Partner's management of the holding company.

18 48. The proposed limited partner structure impedes the Commission's ability to access
19 books, records and other documents that would be relevant to Commission's oversight of the Public
20 Utility Holding Company pursuant to Commission authority under the Affiliated Interest Rules.

21 49. As discussed herein in the Analysis, the expected benefits of the transaction accruing
22 to ratepayers are not sufficient to overcome the risks and uncertainties imposed by the proposed
23 reorganization.

24 50. The record does not permit a finding that the proposed reorganization does not impair
25 the financial status of the public utilities, otherwise prevent them from attracting capital at fair and
26 reasonable terms, or impair their abilities to provide safe, reasonable and adequate service.

27 51. The proposed transaction is not in the public interest.

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CONCLUSIONS OF LAW

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- 1. TEP, UNS Electric and UNS Gas are public service corporations pursuant to the Arizona Constitution Article 15, Arizona Revised Statutes, Title 40 generally, and A.A.C. R14-2-801 et seq.
- 2. UniSource, Saguaro Holdings, Saguaro LP, and Sage are Public Utility Holding Companies pursuant to A.A.C. R14-2-801.4.
- 3. The Commission has jurisdiction over UniSource, Saguaro Holdings, Saguaro LP, Sage and the Investors and the subject matter of the application.
- 4. UniSource provided public notice of the application and hearing as required by law.
- 5. Pursuant to the Arizona Constitution and A.R. S. Title 40 generally, the Commission is required to act in the “public interest” and must consider all of the evidence available in determining the “public interest”.
- 6. The public interest requires that the Commission apply the Affiliated Interest Rues in a manner that will maximize protection to ratepayers.
- 7. Utility ratepayers should not be required to bear the burden of risk resulting from holding company structure or diversification.
- 8. The factors set out in A.A.C. R14-2-803(C) are only a part of the “public interest” inquiry that the Commission must make as part of its consideration of the proposed transaction.
- 9. The record does not permit a conclusion that the proposed transaction does not impair the financial status of the public utilities, otherwise prevent them from attracting capital at fair and reasonable terms, or impair their abilities to provide safe, reasonable and adequate service.
- 10. As structured in the application and modified through testimony, the proposed leveraged buyout and reorganization of UniSource is not in the public interest.

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ORDER

IT IS THEREFORE ORDERED that the application of UniSource Energy Corporation for approval of its Agreement and Plan of Merger with Saguaro Acquisition Corp. is denied.

IT IS FURTHER ORDERED that in future rate proceedings no costs associated with the proposed transaction shall be borne by ratepayers of Tucson Electric Power Company, UNS Gas or UNS Electric.

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

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN	COMMISSIONER	COMMISSIONER
COMMISSIONER	COMMISSIONER	

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ____ day of _____, 2004.

BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT: _____

DISSENT: _____

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SERVICE LIST FOR: UNISOURCE ENERGY CORPORATION

DOCKET NO.: E-04230A-03-0933

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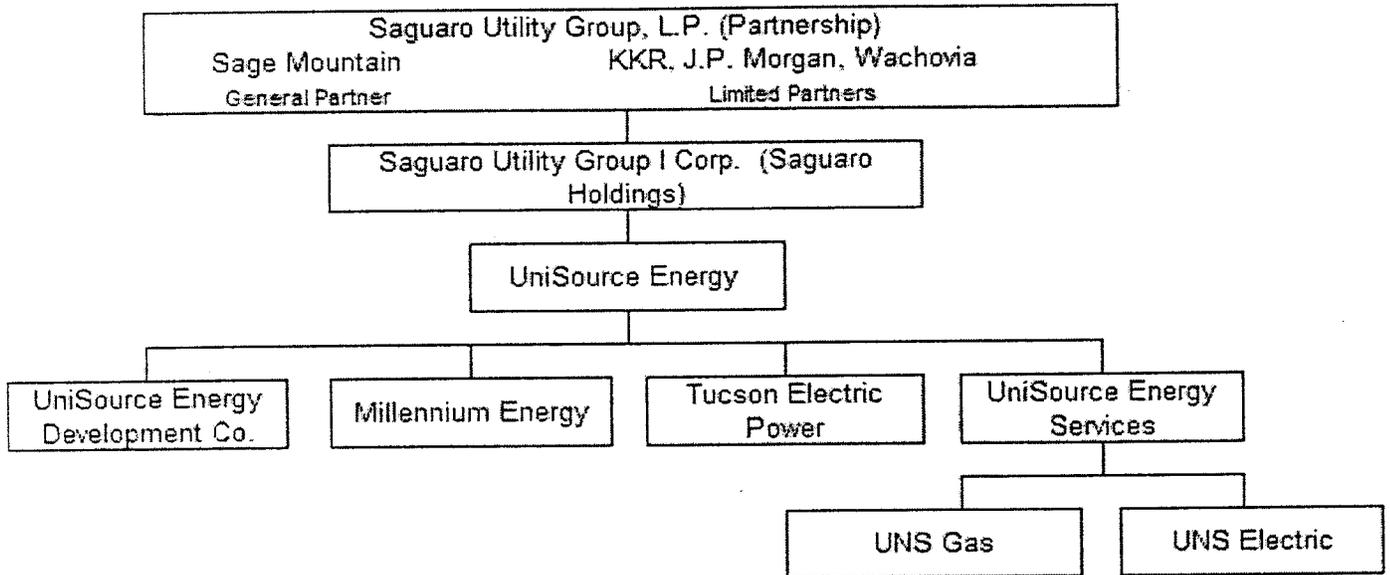
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**STAFF
ATTACHMENT B**

**ORGANIZATIONAL CHART OF APPLICANT'S
PROPOSED POST-MERGER STRUCTURE**

Figure 2



(Figure 2, Reiker Direct at 7).

**Unisource Energy's
Modifications To The
Proposed Conditions**

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A. Financial Integrity and "Ring-Fencing" Conditions.

1. Committed Improvements to Utility Equity Capital Ratios.

- a. At closing, UniSource Energy will make an equity contribution of up to \$168 million and repay the \$95 million intercompany note from UniSource Energy to TEP. TEP will use this cash infusion to retire debt and thereby improve its equity capitalization from approximately 25% to 40% of total capital, calculated as stated in Decision No. 66028.
- b. TEP, UNS Electric and UNS Gas, without prior approval of the Commission, will not issue dividends which comprise more than seventy-five percent (75%) of its current year's earnings if its equity capitalization equals less than 40% of total capital, calculated as stated in Decision No. 66028.
- c. TEP will not make an equity capital distribution of any type (except for otherwise permitted distributions from earnings) that would cause TEP's equity capital, as measured under the ACC rate case method, to fall below 40% of total TEP capital or the level achieved through compliance with the TEP debt reduction condition, absent the prior approval of the Commission.
- d. TEP will continue its policy of reducing its current debt and lease obligations. In particular, TEP will make at least \$300 million of voluntary debt and lease prepayments and buybacks from January 1, 2004 to December 31, 2005 (which includes the cash infusion and debt retirement associated with the merger transaction) and a total of at least \$400 million prior to December 31, 2008. These reductions are in addition to lease debt amortization included in currently scheduled capital lease obligations. Any new TEP debt issuances must be approved by the ACC. In relation to TEP first mortgage bonds which mature in 2008, TEP shall submit to the Director, Utilities Division by March 31, 2008, a report stating its intentions and reasons for the pay-off or refinancing of such debt.

2. Charter Amendments to Ring-Fence Utilities.

- a. Upon closing, TEP, UNS Electric and UNS Gas will amend their respective organizational documents to provide protections to ensure legal separateness from UniSource Energy, Saguaro Holdings and Saguaro LP.

The amendments will provide that each utility company shall not file for bankruptcy protection without the affirmative vote of a designated independent director thereof and, further, each utility, other than in the ordinary course of business with appropriate regard to separateness and corporate formalities, shall:

- 1 (i) not enter into any guaranty, or otherwise become intentionally liable for, or pledge
2 its assets to secure the liability, debts or obligations of any affiliates (other than its
3 subsidiaries);
- 4 (ii) not hold out its credit as being available to satisfy the debts or obligations of any
5 other entity (other than its subsidiaries);
- 6 (iii) maintain accurate and appropriate detailed books, financial records and accounts,
7 including checking and other bank accounts and custodian and other securities
8 safekeeping accounts, that are separate and distinct from those of any other entity;
- 9 (iv) maintain its books, financial records and accounts (including inter-entity
10 transaction accounts) in a manner so that it will not be difficult or costly to
11 segregate, ascertain or otherwise identify its assets and liabilities;
- 12 (v) except with respect to shared expenses and corporate functions, each to be
13 appropriately allocated under the UniSource Energy Cost Allocation Manual, not
14 intentionally commingle any of its assets, funds, liabilities or business functions
15 with the assets, funds, liabilities or business functions of any other entity;
- 16 (vi) observe appropriate corporate procedures and formalities;
- 17 (vii) cause all material transactions and agreements between it and any one or more of
18 its affiliates (including transactions and agreements pursuant to which the assets or
19 property of one is used or to be used by the other) to be entered into in the names of
20 the entities that are parties to the transaction or agreement and to be formally
21 documented in writing;
- 22 (viii) except with respect to shared expenses and corporate functions, each to be
23 appropriately allocated under the UniSource Energy Cost Allocation Manual,
24 conduct transactions with third parties in its name and as an entity that is separate
25 and distinct from its affiliates;
- 26 (ix) except with respect to shared expenses and corporate functions, each to be
27 appropriately allocated under the UniSource Energy Cost Allocation Manual, pay
its own liabilities, expenses and losses only from its own assets;
- (x) except with respect to shared expenses and corporate functions, each to be
appropriately allocated under the UniSource Energy Cost Allocation Manual,
compensate all consultants, independent contractors and agents from its own funds
for services provided to it by such consultants, independent contractors and agents;
- (xi) to the extent that it and its affiliates jointly contract or do business with vendors or
service providers or share overhead expenses, allocate fairly, appropriately and non-
arbitrarily the costs and expenses incurred in so doing between or among such
entities, with the result that each such entity bears its fair share of all such costs and
expenses as provided in the UniSource Energy Cost Allocation Manual;

- 1 (xii) to the extent that it contracts or does business with vendors or service providers
2 where the goods or services are wholly or partially for the benefit of its affiliates,
3 allocate fairly, appropriately and non-arbitrarily the costs incurred in so doing to the
4 entity for whose benefit the goods or services are provided, with the result that each
5 such entity bears its fair share of all such costs as provided in the UniSource Energy
6 Cost Allocation Manual;
- 7 (xiii) to the extent that it shares the same officers or other employees with its affiliates,
8 allocate fairly, appropriately and non-arbitrarily the salaries of and expenses related
9 to providing other benefits to such officers and other employees between or among
10 such entities, with the result that each such entity will bear its fair share of the
11 salary and benefit costs associated with all such common or shared officers or other
12 employees as provided in the UniSource Energy Cost Allocation Manual;
- 13 (xiv) to the extent that it occupies any premises in the same location or shares the use
14 of equipment with its affiliates, allocate fairly, appropriately and non-arbitrarily any
15 rent and overhead expenses among and between such entities with the result that
16 each bears its fair share of all such rent and expenses as provided in the UniSource
17 Energy Cost Allocation Manual;
- 18 (xv) cause its representatives and agents to hold themselves out to third parties as being
19 its representatives or agents, as the case may be, it being understood that it need not
20 have its own dedicated employees;
- 21 (xvi) maintain separate annual financial statements prepared in accordance with
22 generally accepted accounting principles showing its assets and liabilities separate
23 and distinct from those of any other entities (other than its subsidiaries);
- 24 (xvii) to the extent its financial statements are to be consolidated with the financial
25 statements of any other entities (other than a subsidiary), cause to be included in
26 such consolidated financial statements a narrative description of it and its
27 subsidiaries' separate assets, liabilities, business functions and operations to ensure
that such separate assets, liabilities, business functions and operations are readily
distinguishable by any person receiving or relying upon a copy of such consolidated
financial statements;
- (xviii) pay or bear the cost of the preparation of its financial statements, and have such
financial statements audited by an independent certified public accounting firm
(which firm may also audit the financial statements of affiliates, subject to clause
(xii) above);
- (xix) correct any known material misunderstanding regarding its separate identity;
- (xx) not make any loans to any affiliate (other than its subsidiaries) or buy or hold any
indebtedness or other obligations issued by any affiliate (other than its
subsidiaries);

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(xxi) not permit any of its assets to be held in the name of another person, except pursuant to a documented trust or similar arrangement; and

(xxii) maintain an arm's-length relationship with its affiliates and enter into transactions with affiliates only on a commercially reasonable basis.

b. Saguaro Holdings and UniSource Energy will use their reasonable best efforts to ensure that all material debt facilities entered into after the date hereof will include separateness covenants or acknowledgements, as the case may be, which will state in substance that: (a) lenders to Saguaro Holdings and UniSource Energy, in agreeing to become parties to such facilities, are acknowledging that (i) Saguaro Holdings and UniSource Energy are being operated as separate corporate and legal entities from TEP and its utility affiliate, UES, (ii) such lenders are relying for legal credit support for such facilities and the loans thereunder and repayment thereof solely on the credit characteristics (including those based on assets and equity and related dividends from subsidiaries) of Saguaro Holdings and UniSource Energy (as well as any future non-utility entities) and not from any implied or express guarantee by or pledge of assets owned by TEP or UES and (iii) in connection with any appointment of an administrative receiver or the making of an administrative order for instituting any bankruptcy, reorganization, insolvency, wind up or liquidation or any like proceeding under applicable law, in each case which includes TEP or UES or any of the assets or liabilities of these utilities, the lenders do not have recourse to or claim to reliance on any implied or express guarantee or pledge of assets owned by TEP or UES; and (b) Saguaro Holdings and UniSource Energy will be operated as separate corporate and legal entities and neither Saguaro Holdings nor UniSource Energy will take any legal action, whether in connection with a bankruptcy or similar proceeding or otherwise, asserting the contrary of any of the foregoing in either clause (a) or (b).

3. Commission Oversight, Authority and Reporting on Financial Matters.

a. UniSource Energy, TEP, UNS Electric and UNS Gas will maintain their accounting records at UniSource Energy's corporate headquarters.

b. Saguaro Holdings and UniSource Energy will file with the Commission: (i) quarterly financial statements and annual audited financial statements (which may be consolidated) and (ii) a copy of any filings made with the Securities and Exchange Commission or, in the event that such filings are not made, any written financial information delivered to holders of its indebtedness for borrowed money.

c. In the event that Saguaro Holdings, Saguaro LP, any of Saguaro LP's partners or any person controlled by any of Saguaro LP's partners or any of J.P. Morgan Partners, L.L.C. ("JPMP"), Kohlberg Kravis Roberts & Co., L.P. ("KKR") and Wachovia Capital Partners ("WCP") or any person controlled by JPMP, KKR or WCP provides material services or products to TEP, UNS Electric or UNS Gas, (i) such services or products will be supplied in accordance with the provisions of the applicable utility's

Code of Conduct or Cost Allocation Manual and a report will be filed annually detailing the nature of and costs associated with the transaction and (ii) Saguaro Holdings, Saguaro LP, any of Saguaro LP's partners or any person controlled by any of Saguaro LP's partners or any of JPMP, KKR and WCP or any person controlled by JPMP, KKR or WCP will provide the Commission access to their respective books and records (or copies thereof) to the degree required to audit, examine or otherwise investigate such transaction. Upon request, such books and records (or copies thereof) will be made available in Tucson, Arizona.

B. Continued Service Quality and Reliability Conditions.

4. Minimum O&M Expense and Capital Commitments.

TEP, UNS Electric and UNS Gas will not, without the prior approval of the Commission, spend less than an aggregate amount of approximately \$1.5 billion in operating and maintenance expenses and capital expenditures for the years 2005-2008 (which equates to a yearly average level of \$375 million for those years). TEP will submit a report annually in 2006 to 2009 to the Director, Utilities Division describing the prior year's expenditures and statistics on customer and usage growth.

C. Affiliate Relationships Conditions.

5. Commitments to Customer Privacy.

TEP, UNS Electric and UNS Gas will not share with UniSource Energy, Saguaro Holdings, Saguaro LP, any of Saguaro LP's partners or any person controlled by any of Saguaro LP's partners or any of JPMP, KKR and WCP or any person controlled by JPMP, KKR or WCP any non-aggregated information made available to it solely by virtue of the company/customer relationship, such as billing information and services received by a customer; provided, however, that such information may be shared to the extent necessary for such entities to make appropriate decisions concerning the delivery of necessary utility services to such customers and, if shared, may only be used for such purpose.

6. Revised Cost Allocation Manual.

UniSource Energy, TEP, UNS Electric and UNS Gas will review and, where appropriate, revise their Codes of Conduct and Cost Allocation Manuals to include appropriate provisions to govern transactions and interactions between the utilities, on the one hand, and UniSource Energy, Saguaro Holdings, Saguaro LP, any of Saguaro LP's partners or any person controlled by any of Saguaro LP's partners or any of JPMP, KKR and WCP or any person controlled by JPMP, KKR and WCP, on the other hand. The Codes of Conduct and Cost Allocation Manuals will specifically address the provision of services or products by or to TEP, UNS Gas or UNS Electric with respect to UniSource Energy, Saguaro Holdings, Saguaro LP, any of Saguaro LP's partners and any person controlled by any of Saguaro LP's partners or any of JPMP, KKR and WCP or any person controlled by JPMP, KKR or WCP. The utilities will submit their revised Codes of Conduct and Cost

1 Allocation Manuals to the Commission Staff for its review within 90 days of the closing of
2 the transaction.

3 7. Waivers to Affiliated Interest Rules.

4 To the extent that any condition to the Commission's approval of the Merger Agreement
5 differs from the terms of a prior waiver to the Affiliate Interest Rules obtained by
6 UniSource Energy, the terms of these conditions shall be controlling. Saguaro Holdings
7 and Saguaro LP will, through UniSource Energy, request from the Commission any new
8 waivers to the Affiliate Interest Rules that they may wish to obtain.

9 **D. Governance, Oversight and Community Presence Conditions.**

10 8. Separate Utility-Level Boards with Independent Directors.

11 TEP, UES, UNS Electric and UNS Gas each will have a Board of Directors comprised of
12 at least five (5) persons. At least two (2) of the Board members will be Arizona residents
13 and at least two (2) will qualify as "independent" of UniSource Energy, Saguaro Holdings,
14 Saguaro LP, any of Saguaro LP's partners and KKR, JPMP and WCP and any entities they
15 control, as the term "independent" is interpreted under Section 303A of the New York
16 Stock Exchange Listing Company Manual.

17 9. Maintenance of Headquarters.

18 UniSource Energy and TEP are headquartered in Tucson, Arizona. UNS Electric is
19 headquartered in Kingman, Arizona and UNS Gas is headquartered in Flagstaff, Arizona.
20 UniSource Energy, TEP, UNS Electric and UNS Gas will not, without prior Commission
21 approval, move their respective business headquarters from the cities where those
22 headquarters are now located.

23 10. Maintenance of Arizona Operating Locations.

24 UniSource Energy, TEP, UNS Electric and UNS Gas will continue to maintain operating
25 locations and field offices in Arizona, as appropriate, to sustain the quality of their service.

26 11. Commission Authority Over Non-Utility Investments.

27 Saguaro LP, Saguaro Holdings and UniSource Energy will not, without prior Commission
approval, make any new, material non-regulated, non-utility investments (other than
investments in Millennium ventures) that are not part of the electric energy business.

12. Commission Approval of Changes to General Partner of Saguaro LP.

Saguaro LP will not permit a direct or indirect change in its general partner or in the
membership or ownership thereof without prior Commission approval, except that the
limited partners of Saguaro LP may, consistent with the terms of Saguaro LP's agreement
of limited partnership, remove Sage Mountain and appoint an interim replacement general
partner without prior Commission approval upon the death or permanent disability

1 of Sage Mountain's controlling member or a finding that Sage Mountain or its controlling
 2 member (1) has been convicted of a felony, (2) has committed fraud against Saguaro LP,
 3 (3) has acted or omitted to take action on behalf of Saguaro LP, which act or omission
 4 constitutes gross negligence or willful misconduct, (4) has breached any material provision
 5 of the agreement of limited partnership or any of its fiduciary duties thereunder, (5) is the
 6 subject of bankruptcy proceedings or otherwise has sought relief under any bankruptcy or
 7 insolvency laws, (6) has liquidated, dissolved or otherwise ceased to be in existence, (7)
 8 has suffered a change in control not permitted by the agreement of limited partnership or
 9 (8) has failed to comply with applicable laws. Following any such removal and
 10 appointment of an interim replacement general partner, Saguaro LP will promptly seek
 11 Commission approval for a permanent replacement general partner and, if the Commission
 12 rejects such permanent replacement general partner, Saguaro LP will undertake to find an
 13 alternate replacement general partner that is reasonably acceptable to the Commission.

13. Commission Approval of Material Changes to Saguaro LP Limited Partners.

14 Saguaro LP will not permit any ownership change among its limited partners without prior
 15 Commission approval if such change would result in any new limited partner obtaining
 16 more than 10% of the economic interests in Saguaro LP (other than limited partners who
 17 are affiliates of existing limited partners or are managed by the same general partner or
 18 member or affiliate thereof prior to such ownership change).

14. Commission Access to Records.

15 Sage Mountain, Saguaro LP and Saguaro Holdings will provide full access to any of their
 16 records on the same basis as provided by UniSource Energy, TEP, UNS Gas and UNS
 17 Electric and, upon request, will make such books and records (or copies thereof) available
 18 in Tucson, Arizona.

15. Make firm commitments regarding community support.

19 Saguaro LP, Saguaro Holdings, UniSource Energy and their utility subsidiaries shall
 20 continue to support and, where appropriate, enhance charitable and community corporate
 21 "giving programs," education, environmental, economic and philanthropic partnerships and
 22 consumer partnerships at funding levels, in the aggregate, equal to or greater than the
 23 amounts expended from September 1, 2003 through August 31, 2004.

24 **E. Non-Recoverability of Merger/Affiliate Costs Conditions.**

25 16. No Recovery of Partnership Operations Costs.

26 TEP, UNS Gas and UNS Electric will not seek recovery in any future Arizona rate
 27 proceeding of any costs incurred by Saguaro LP with respect to operations before or after
 the merger of UniSource Energy and Saguaro Acquisition.

17. No Recovery of Acquisition Premium and Transaction Costs.

TEP, UNS Gas and UNS Electric shall not seek recovery of (i) any acquisition premium related to the merger of UniSource Energy and Saguaro Acquisition or (ii) any costs associated with the merger of UniSource Energy and Saguaro Acquisition in any future Arizona rate proceeding.

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**STAFF
ATTACHMENT A**

NECESSARY CONDITIONS

The following are the conditions Staff has indicated are necessary in order for the transaction to be appropriate for the Commission to even consider approving.

A. Financial Integrity and "Ring-Fencing" Conditions.

1. Committed Improvements to Utility Equity Capital Ratios.

- a. At closing, UniSource Energy will make an equity contribution of up to \$168 million and repay the \$95 million intercompany note from UniSource Energy to TEP. TEP will use this cash infusion to retire debt and thereby improve its equity capitalization from approximately 25% to 40% of total capital, calculated as stated in Decision No. 66028. (Pignatelli Rebuttal at 12-13).
- b. TEP, UNS Electric and UNS Gas, without prior approval of the Commission, will not issue dividends which comprise more than seventy-five percent (75%) of its current year's earnings if its equity capitalization equals less than 40% of total capital, calculated as stated in Decision No. 66028 (the "ACC rate case method"). (Pignatelli Rebuttal at 13).
- c. TEP will not make an equity capital distribution of any type (except for otherwise permitted distributions from earnings) that would cause TEP's equity capital, as measured under the ACC rate case method, to fall below 40% of total TEP capital or the level achieved through compliance with the TEP debt reduction condition, absent the prior approval of the Commission. (Antonuk Surrebuttal at 4, line 21-26).
- d. Unless otherwise first approved by the Commission, TEP will make total net reductions in its long-term debt and capital lease debt of at least \$500 million by the end of calendar year 2008, which includes an average of \$30 million of annual voluntary debt and lease prepayments and buybacks between 2006 and 2008¹. At least \$300 million of the net reduction is long-term debt and capital-lease debt shall occur by the end of calendar year 2005, which includes \$30 million of annual voluntary debt and lease prepayments and buybacks by year-end 2005². The required net reductions in TEP's long-term debt and capital lease debt shall be in addition to lease debt amortization included in currently scheduled capital-lease obligations. (Antonuk Surrebuttal at 4-5).

¹ (as offered in UniSource rebuttal testimony, page 13, James Pignatelli rebuttal testimony)

² (as offered in UniSource rebuttal testimony, page 13, James Pignatelli rebuttal testimony)

2. Charter Amendments to Ring-Fence Utilities.

- 1
- 2 a. Upon closing, TEP, UNS Electric and UNS Gas will amend their respective
- 3 organizational documents to provide protections to ensure legal separateness
- 4 from UniSource Energy, Saguaro Holdings and Saguaro LP.

5 The amendments will provide that each utility company shall not file for

6 bankruptcy protection without the affirmative vote of a designated independent

7 director thereof and, further, each utility, other than in the ordinary course of

8 business with appropriate regard to separateness and corporate formalities,

9 shall:

- 10 (i) not enter into any guaranty, or otherwise become intentionally liable
- 11 for, or pledge its assets to secure the liability, debts or obligations of
- 12 any affiliates (other than its subsidiaries);
- 13 (ii) not hold out its credit as being available to satisfy the debts or
- 14 obligations of any other entity (other than its subsidiaries);
- 15 (iii) maintain accurate and appropriate detailed books, financial records and
- 16 accounts, including checking and other bank accounts and custodian
- 17 and other securities safekeeping accounts, that are separate and distinct
- 18 from those of any other entity;
- 19 (iv) maintain its books, financial records and accounts (including inter-
- 20 entity transaction accounts) in a manner so that it will not be difficult or
- 21 costly to segregate, ascertain or otherwise identify its assets and
- 22 liabilities;
- 23 (v) except with respect to shared expenses and corporate functions, each to
- 24 be appropriately allocated under the UniSource Energy Cost Allocation
- 25 Manual, not intentionally commingle any of its assets, funds, liabilities
- 26 or business functions with the assets, funds, liabilities or business
- 27 functions of any other entity;
- 28 (vi) observe appropriate corporate procedures and formalities;
- (vii) cause all material transactions and agreements between it and any one
- or more of its affiliates (including transactions and agreements pursuant
- to which the assets or property of one is used or to be used by the other)
- to be entered into in the names of the entities that are parties to the
- transaction or agreement and to be formally documented in writing;
- (viii) except with respect to shared expenses and corporate functions, each to
- be appropriately allocated under the UniSource Energy Cost Allocation
- Manual, conduct transactions with third parties in its name and as an
- entity that is separate and distinct from its affiliates;

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- (ix) except with respect to shared expenses and corporate functions, each to be appropriately allocated under the UniSource Energy Cost Allocation Manual, pay its own liabilities, expenses and losses only from its own assets;
- (x) except with respect to shared expenses and corporate functions, each to be appropriately allocated under the UniSource Energy Cost Allocation Manual, compensate all consultants, independent contractors and agents from its own funds for services provided to it by such consultants, independent contractors and agents;
- (xi) to the extent that it and its affiliates jointly contract or do business with vendors or service providers or share overhead expenses, allocate fairly, appropriately and non-arbitrarily the costs and expenses incurred in so doing between or among such entities, with the result that each such entity bears its fair share of all such costs and expenses as provided in the UniSource Energy Cost Allocation Manual;
- (xii) to the extent that it contracts or does business with vendors or service providers where the goods or services are wholly or partially for the benefit of its affiliates, allocate fairly, appropriately and non-arbitrarily the costs incurred in so doing to the entity for whose benefit the goods or services are provided, with the result that each such entity bears its fair share of all such costs as provided in the UniSource Energy Cost Allocation Manual;
- (xiii) to the extent that it shares the same officers or other employees with its affiliates, allocate fairly, appropriately and non-arbitrarily the salaries of and expenses related to providing other benefits to such officers and other employees between or among such entities, with the result that each such entity will bear its fair share of the salary and benefit costs associated with all such common or shared officers or other employees as provided in the UniSource Energy Cost Allocation Manual;
- (xiv) to the extent that it occupies any premises in the same location or shares the use of equipment with its affiliates, allocate fairly, appropriately and non-arbitrarily any rent and overhead expenses among and between such entities with the result that each bears its fair share of all such rent and expenses as provided in the UniSource Energy Cost Allocation Manual;
- (xv) cause its representatives and agents to hold themselves out to third parties as being its representatives or agents, as the case may be, it being understood that it need not have its own dedicated employees;
- (xvi) maintain separate annual financial statements prepared in accordance with generally accepted accounting principles showing its assets and liabilities separate and distinct from those of any other entities (other than its subsidiaries);

1 (xvii) to the extent its financial statements are to be consolidated with the
 2 financial statements of any other entities (other than a subsidiary),
 3 cause to be included in such consolidated financial statements a
 4 narrative description of it and its subsidiaries' separate assets,
 5 liabilities, business functions and operations to ensure that such
 6 separate assets, liabilities, business functions and operations are readily
 7 distinguishable by any person receiving or relying upon a copy of such
 8 consolidated financial statements;

9 (xviii) pay or bear the cost of the preparation of its financial statements, and
 10 have such financial statements audited by an independent certified
 11 public accounting firm (which firm may also audit the financial
 12 statements of affiliates, subject to clause (H)(xii) above);

13 (xix) correct any known material misunderstanding regarding its separate
 14 identity;

15 (xx) not make any loans to any affiliate (other than its subsidiaries) or buy
 16 or hold any indebtedness or other obligations issued by any affiliate
 17 (other than its subsidiaries);

18 (xxi) not permit any of its assets to be held in the name of another person,
 19 except pursuant to a documented trust or similar arrangement; and

20 (xxii) maintain an arm's-length relationship with its affiliates and enter into
 21 transactions with affiliates only on a commercially reasonable basis.

22 (Pignatelli Rebuttal at 13, line 27-15, line 17)

- 23 b. All Saguaro and UniSource debt will include separateness covenants, which will
 24 remain effective as long as TEP and UES are owned by Saguaro and UniSource,
 25 and which will state that : (a) Saguaro and UniSource and separately TEP and its
 26 utility affiliate UES, are being operated as separate corporate and legal entities,
 27 and that lenders to Saguaro and UniSource, in agreeing to make loans, are relying
 28 and have relied solely on the creditworthiness of Saguaro and UniSource based on
 the assets and equity interests owned by those entities. The repayment of Saguaro
 and UniSource indebtedness will be made solely from the assets of Saguaro and
 UniSource and not from any assets or pledge of assets of TEP or UES. Saguaro,
 UniSource, and their respective lenders will not take any steps for the purpose of
 procuring the appointment of an administrative receiver or the making of an
 administrative order for instituting any bankruptcy, reorganization, insolvency,
 wind up or liquidation, or any like proceeding under applicable law which includes
 TEP or UES or any of the assets or liabilities of these utilities; and (b) Saguaro and
 UniSource agree that any future material indebtedness will comply with the
 foregoing restrictions. (Antonuk Surrebuttal at 7).

Staff further recommends that if a waiver of this provision is sought and granted
 that the Commission require a specified form of compensation for the utility's
 customers. (Tr. at 1164 line 22-116, line 6).

1 3. Commission Oversight, Authority and Reporting on Financial Matters.

- 2 a. UniSource Energy, TEP, UNS Electric and UNS Gas will maintain their
3 accounting records at UniSource Energy's corporate headquarters. (Pignatelli
4 Rebuttal at 15).
- 5 b. Saguaro Holdings and UniSource Energy will file with the Commission: (i)
6 quarterly financial statements and annual audited financial statements (which
7 may be consolidated) and (ii) a copy of any filings made with the Securities
8 and Exchange Commission or, in the event that such filings are not made, any
9 written financial information delivered to holders of its indebtedness for
10 borrowed money. (Pignatelli Rebuttal at 15)
- 11 c. In the event that Saguaro Holdings, Saguaro LP, any of Saguaro LP's partners
12 or any person controlled by any of Saguaro LP's partners or any of J.P.
13 Morgan Partners, L.L.C. ("JPMP"), Kohlberg Kravis Roberts & Co., L.P.
14 ("KKR") and Wachovia Capital Partners ("WCP") or any person controlled by
15 JPMP, KKR or WCP provides material services or products to TEP, UNS
16 Electric or UNS Gas, (i) such services or products will be supplied in
17 accordance with the provisions of the applicable utility's Code of Conduct or
18 Cost Allocation Manual and a report will be filed annually detailing the nature
19 of and costs associated with the transaction and (ii) Saguaro Holdings, Saguaro
20 LP, any of Saguaro LP's partners or any person controlled by any of Saguaro
21 LP's partners or any of JPMP, KKR and WCP or any person controlled by
22 JPMP, KKR or WCP will provide the Commission access to their respective
23 books and records (or copies thereof) to the degree required to audit, examine
24 or otherwise investigate such transaction. Upon request, such books and
25 records (or copies thereof) will be made available in Tucson, Arizona. (Exhibit
26 A-3)

18 **B. Continued Service Quality and Reliability Conditions.**

- 19 4. Minimum O&M Expense and Capital Commitments:
- 20 a. TEP, UNS Electric and UNS Gas shall fund, a commission-sponsored
21 management and operations audit to commence not more than 18 months after
22 the ownership transition, to be conducted by Staff and a firm selected by the
23 Commission, with the funding amount not less than \$400,000. (Antonuk Direct
24 at 67-68).
- 25 b. UniSource shall maintain accounting and business management records in the
26 same form as kept now, unless approved by the Commission. (Antonuk Direct
27 at 68, line 1-3).

26 **C. Affiliate Relationships Conditions.**

- 27 5. Commitments to Customer Privacy.

28 TEP, UNS Electric and UNS Gas will not share with UniSource Energy, Saguaro
Holdings, Saguaro LP, any of Saguaro LP's partners or any person controlled by any

1 of Saguaro LP's partners or any of JPMP, KKR and WCP or any person controlled by
 2 JPMP, KKR or WCP any non-aggregated information made available to it solely by
 3 virtue of the company/customer relationship, such as billing information and services
 4 received by a customer; provided, however, that such information may be shared to
 5 the extent necessary for such entities to make appropriate decisions concerning the
 6 delivery of necessary utility services to such customers and, if shared, may only be
 7 used for such purpose. (Exhibit A-3)

8 6. Revised Cost Allocation Manual.

9 UniSource Energy, TEP, UNS Electric and UNS Gas will review and, where
 10 appropriate, revise their Codes of Conduct and Cost Allocation Manuals to include
 11 appropriate provisions to govern transactions and interactions between the utilities, on
 12 the one hand, and UniSource Energy, Saguaro Holdings, Saguaro LP, any of Saguaro
 13 LP's partners or any person controlled by any of Saguaro LP's partners or any of
 14 JPMP, KKR and WCP or any person controlled by JPMP, KKR and WCP, on the
 15 other hand. The Codes of Conduct and Cost Allocation Manuals will specifically
 16 address the provision of services or products by or to TEP, UNS Gas or UNS Electric
 17 with respect to UniSource Energy, Saguaro Holdings, Saguaro LP, any of Saguaro
 18 LP's partners and any person controlled by any of Saguaro LP's partners or any of
 19 JPMP, KKR and WCP or any person controlled by JPMP, KKR or WCP. The utilities
 20 will submit their revised Codes of Conduct and Cost Allocation Manuals to the
 21 Commission Staff for its review within 90 days of the closing of the transaction.
 22 (Exhibit A-3)

23 7. Waivers to Affiliated Interest Rules.

24 Any waiver of the Affiliated Interest Rules ("Waiver") previously granted to
 25 UniSource shall be deemed expired 60 days after an order approving the merger,
 26 unless UniSource has filed a request with the Commission to reconsider the waiver.
 27 Any waiver submitted for such reconsideration by the Commission shall remain in
 28 effect until an order is issued pursuant to the request. (Tr. at 115-16).

29 **D. Governance, Oversight and Community Presence Conditions.**

30 8. Separate Utility-Level Boards with Independent Directors.

31 TEP, UES, UNS Electric and UNS Gas each will have a Board of Directors comprised
 32 of at least five (5) persons. At least two (2) of the Board members will be Arizona
 33 residents and at least two (2) will qualify as "independent" of UniSource Energy,
 34 Saguaro Holdings, Saguaro LP and, any of Saguaro LP's partners and KKR, JPMP
 35 and WCP and any entities they control, as the term "independent" is interpreted under
 36 Section 303A of the New York Stock Exchange Listing Company Manual. (Pignatelli
 37 Rebuttal at 17).

38 9. Maintenance of Headquarters.

UniSource Energy and TEP are headquartered in Tucson, Arizona. UNS Electric is
 headquartered in Kingman, Arizona and UNS Gas is headquartered in Flagstaff,
 Arizona. UniSource Energy, TEP, UNS Electric and UNS Gas will not, without prior

1 Commission approval, move their respective business headquarters from the cities
2 where those headquarters are now located. (Pignatelli Rebuttal at 17).

3 10. Maintenance of Arizona Operating Locations.

4 UniSource Energy, TEP, UNS Electric and UNS Gas will continue to maintain
5 operating locations and field offices in Arizona, as appropriate, to sustain the quality
6 of their service. Id.

7 11. Commission Authority Over Non-Utility Investments.

8 Saguaro LP, Saguaro Holdings and UniSource Energy will not, without prior
9 Commission approval, make any new, material non-regulated, non-utility investments,
10 other than those required to provide utility service. (Antonuk Surrebuttal at 9, line 10-
11 23).

12 12. Commission Approval of Changes to General Partner of Saguaro LP.

13 Saguaro LP will not permit a direct or indirect change in its general partner or in the
14 membership or ownership thereof without prior Commission approval, except that the
15 limited partners of Saguaro LP may, consistent with the terms of Saguaro LP's
16 agreement of limited partnership, remove Sage Mountain and appoint an interim
17 replacement general partner without prior Commission approval upon the death or
18 permanent disability of Sage Mountain's controlling member or a finding that Sage
19 Mountain or its controlling member (1) has been convicted of a felony, (2) has
20 committed fraud against Saguaro LP, (3) has acted or omitted to take action on behalf
21 of Saguaro LP, which act or omission constitutes gross negligence or willful
22 misconduct, (4) has breached any material provision of the agreement of limited
23 partnership or any of its fiduciary duties there under, (5) is the subject of bankruptcy
24 proceedings or otherwise has sought relief under any bankruptcy or insolvency laws,
25 (6) has liquidated, dissolved or otherwise ceased to be in existence, (7) has suffered a
26 change in control not permitted by the agreement of limited partnership or (8) has
27 failed to comply with applicable laws. Following any such removal and appointment
28 of an interim replacement general partner, Saguaro LP will promptly seek
Commission approval for a permanent replacement general partner and, if the
Commission rejects such permanent replacement general partner, Saguaro LP will
undertake to find an alternate replacement general partner that is reasonably
acceptable to the Commission. (Pignatelli Rebuttal at 17-18; *see also*, Antonuk
Surrebuttal at 15-16).

13. Commission Approval of Material Changes to Saguaro LP Limited Partners.

Saguaro LP will not permit any ownership change among its limited partners without
prior Commission approval if such change would result in any new limited partner(s)
obtaining in aggregate more than 10% of the economic interests in Saguaro LP. (Tr. at
593-94; *see also*, Tr. 539-46; Antonuk Surrebuttal at 16, line 9-11).

1 14. Commission Access to Records.

2 Sage Mountain, Saguaro LP and Saguaro Holdings will provide full access to any of
3 their records on the same basis as provided by UniSource Energy, TEP, UNS Gas and
4 UNS Electric and, upon request, will make such books and records (or copies thereof)
5 available in Tucson, Arizona. (Pignatelli Rebuttal at 18).

6 15. Make firm commitments regarding community support.

7 Saguaro LP, Saguaro Holdings, UniSource Energy and their utility subsidiaries shall
8 continue to support (in not only monetary contributions, but also non-cash resources
9 made available at corporate direction and corporate support of employee community
10 involvement) and, where appropriate, enhance charitable and community corporate
11 "giving programs," education, environmental, economic and philanthropic
12 partnerships and consumer partnerships at funding levels, in the aggregate, equal to or
13 greater than the amounts expended in calendar year 2003 from September 1, 2003
14 through August 31, 2004. (Antonuk Surrebuttal at 17, line 8-11).

15 **E. Non-Recoverability of Merger/Affiliate Costs Conditions.**

16 16. No Recovery of Partnership Operations Costs.

17 TEP, UNS Gas and UNS Electric will not seek recovery in any future Arizona rate
18 proceeding of any costs incurred by Saguaro LP with respect to operations before or
19 after the merger of UniSource Energy and Saguaro Acquisition. (Pignatelli Rebuttal at
20 18).

21 17. No Recovery of Acquisition Premium and Transaction Costs.

22 TEP, UNS Gas and UNS Electric shall not seek recovery of (i) any acquisition
23 premium related to the merger of UniSource Energy and Saguaro Acquisition or (ii)
24 any costs associated with the merger of UniSource Energy and Saguaro Acquisition in
25 any future Arizona rate proceeding. Id.