BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

DOCKET NO. E-04230A-03-0933

REDACTED

DIRECT

TESTIMONY

OF

JOHN ANTONUK

PRESIDENT

THE LIBERTY CONSULTING GROUP

APRIL 30, 2004

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

Mr. Antonuk's testimony describes Staff's examination of whether the proposed acquisition of UniSource Energy Corporation by a private equity partnership in a leveraged buyout should be approved. The testimony begins with a discussion of how other state utility regulatory commissions have treated similar transactions. Staff shows that commissions typically require substantial commitments as a condition of transaction approval. These conditions address a number of areas: (a) utility financial segregation and protection, (b) service quality and reliability assurance, (c) affiliate transactions and costs, (d) governance, (e) regulatory oversight and access to records, and (f) community presence.

Mr. Antonuk's testimony discusses how commissions require more than statements of plan or intent, calling for specific, monitorable, and enforceable commitments. The applicants here have made some statements of plan and intent, but have made few if any commitments that this Commission can monitor and enforce. The testimony discusses the specific shortcomings of the application in addressing the drawbacks and risks that this merger presents. They include:

1. Increase in leverage at the utility level and lack of "ring-fencing" protections
2. Lack of assurance that all free cash flow will be used to reduce debt levels
3. No effective method for ensuring continued service quality
4. Absence of limits on added investments that can be made
5. Ability to transfer ownership interests without Commission approval
6. Potential for conflicts of interest from the activities of the partners
7. No commitment to retaining a utility-level board with outside membership
8. Unacceptable potential for operational intrusion by limited partners
9. Insufficient assurance of continued Commission oversight and authority
10. Other statements of intention not translated into enforceable commitments.

The transaction as structured fails to provide many protections, in the form of commitments, that are appropriate here. The testimony describes how the weak financial condition of UniSource, compared to its peers, and the private ownership feature of this transaction create added need for Commission concern about and attention to these issues that other Commissions have addressed. Staff's testimony raises particular concerns about the financial risks that the transaction, as structured would create. These concerns merit special attention in light of the long-term "make-well" program that the Commission has supported for so long at TEP.

Given these and the other concerns, Staff concludes that (a) the absence of substantial commitments by the applicants in a number of areas, and (b) the financial risks created by lack of financial protection ("ring-fencing") of UniSource's utilities call for disapproval of the merger as proposed. The proposal as presented satisfies neither the public interest nor the specific standards of R14-2-803. On this basis, Staff recommends against approval of the transaction as proposed. However Staff believes that the conditions discussed herein, if agreed to, would significantly mitigate the risks associated with this transaction. Mr. Antonuk's testimony discusses Staff's recommended conditions to date, and provides support for them.

Staff's recommended conditions to protect utility financial integrity would require that the applicants make commitments to:

1. Maintain minimum utility equity capital ratios
2. Attain targeted credit ratings improvements
3. Separately negotiate and structure utility financing arrangements
4. Fully segregate utility funds in separate cash management systems
5. Not pledge utility assets, financial support, or cash flow for affiliate benefit
6. Provide utility protection from bankruptcy and insolvency of affiliates
7. Prohibit inter-company loans
8. Assure Commission oversight, authority, and reporting on financial matters.

To ensure continued service quality and reliability, Staff recommends that the applicants:

9. Agree to a management and operations audit to determine if the company is acting in accord with the obligation to provide safe, efficient, and reliable service
10. Acknowledge the Commission's intent to consider adoption of retail service quality standards applicable to them.

Regarding affiliate issues, Staff recommends that the applicants:

11. Agree to an interpretation of the term "affiliate" sufficiently broad to include companies in which the partners (or their related entities) have interests
12. Develop and submit for Commission approval an appropriate Code of Conduct and a Cost Allocation Manual governing utility interactions with affiliates
13. Provide justification for continuing any waivers to the Affiliated Interest Rules adopted in prior Commission orders and for any additional waivers being sought.

In the areas of governance, oversight, and community presence, Staff recommends that the applicants:

14. Retain a utility-level board with substantial outside membership
15. Commit to obtaining Commission approval before moving operations locations
16. Agree there can be no material partner changes without Commission approval
17. Provide full access to records on matters directly and indirectly affecting utilities
18. Make firm commitments regarding community support.

Staff recommends firm commitments on the non-recoverability of certain costs:

19. Preclude recovery of partnership post-merger operations costs
20. Preclude recovery of acquisition premium and transaction costs.

1 **Introduction**

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

3 A. My name is John Antonuk. I am the President of The Liberty Consulting Group. My
4 business address is 65 Main Street, Box 237, Quentin, PA 17083.

5

6 **Q. Please describe your educational background and professional experience.**

7 A. I graduated in 1973 from Dickinson College, earning a bachelors degree, with honors. I
8 graduated in 1976 from the Dickinson School of Law, earning a juris doctor degree, with
9 honors. I began my career in 1975 as an investigator for the litigation section of the
10 Pennsylvania Attorney General's office. I then spent several years as assistant counsel to
11 the Pennsylvania Public Utility Commission, for which I conducted administrative and
12 civil litigation involving a wide variety of case types in the electricity, natural gas,
13 telecommunications, water, and transportation industries. I also served in a number of
14 capacities on a variety of matters involving commission administration and operations.

15

16 I then served as the head of the service and facilities section of Pennsylvania Power &
17 Light (PP&L) Company's regulatory-affairs department. I left PP&L to begin consulting
18 in the utility industry in 1982. I managed the litigation-services practice of Management
19 Analysis Company, a consulting firm that specialized in the electric-utility industry.

20

1 I am one of the founders of Liberty, which was established 17 years ago. I have held
2 management or lead roles on over 150 projects over the 22 years that I have been
3 consulting in the utility industries.
4
5 **Q. Have you participated previously in state commission proceedings?**
6 A. Yes. I have been engaged in many state utility regulatory proceedings in the electric,
7 natural gas, and telecommunications industries in my time as a utility consultant Much
8 but not all of it has been on behalf of commissions or their staffs. I have served as a staff
9 witness, an independent witness appearing on the commission's behalf, a contracted
10 administrative law judge, a facilitator, an arbitrator, and a commission advisor.
11 Attachment A to this testimony describes my roles in such proceedings in more detail.
12
13 **Q. Please describe the business of The Liberty Consulting Group.**
14 A. Liberty is a management-consulting firm that has been serving regulators and managers in
15 the utility industries for 17 years. Liberty has performed over 250 utility-industry
16 engagements. Liberty's experience includes work involving energy and
17 telecommunications utilities across the country. Liberty has performed or is performing
18 substantial engagements for utility regulatory authorities in about two thirds of the states.
19 These states include:

Arizona
Arkansas
Colorado
Connecticut
Delaware
District of Columbia
Georgia
Hawaii
Idaho
Illinois
Iowa
Kentucky
Maine
Maryland
Minnesota
Mississippi
Montana
Nebraska
New Hampshire
New Jersey
New Mexico
New York
North Dakota
Ohio
Oklahoma
Oregon
Pennsylvania
South Dakota
Tennessee
Utah
Vermont
Virginia
Washington
Wyoming

Q. What work in the regulatory aspects of utility finance, service reliability, holding companies, affiliates, and changes in utility ownership and control has Liberty performed?

A. This work includes NUI, the Consolidated Edison/Northeast Utilities merger, the competitive services offerings of New Jersey's four major electricity distribution utilities, Commonwealth Edison's reliability problems in the Chicago metropolitan area, Public Service Electric & Gas, Dominion Resources, management and operations audits of a significant number of utilities, and affiliate transaction, cost, and allocation examinations involving a number of additional utilities. These comprise examples of the kinds of work Liberty and I have done in connection with issues that I discuss in this testimony. Attachment B to this testimony describes these engagements in more detail.

Purpose of Testimony

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

A. I will describe the kinds of conditions that other state utility regulatory commissions have imposed in reviewing similar transactions. I will describe the areas of this proposed reorganization where the application of similar types of conditions may be applicable.

The main purpose of my testimony is to set forth the view of the Utilities Division Staff ("Staff") on the merits of the reorganization of UniSource Energy Corporation ("UniSource" or "Company"), both as proposed by the Company and as potentially modified by the introduction of certain specific conditions.

Summary of Testimony

Q. Please summarize your testimony as it relates to the question of imposing conditions on the reorganization proposed in these proceedings.

A. First, it is common for commissions considering similar transactions to impose conditions in a wide range of areas, including financial protection, service reliability, governance, affiliate transactions, and access to information, just to cite some examples. Second, statements of explicit and precise commitment, rather than of mere plan or intent, are significantly more important in assuring that the risks of change brought about by reorganizations such as this one are mitigated sufficiently. Specifically, there should be adequate assurances that a merger or reorganization will not cause harm or risk of harm, and will serve the public interest by creating discernible net positive benefits sufficient to balance the risks that arise from changes in circumstances such as those at issue here. Third, the restructuring proposed here does not offer substantial commitments to address the kinds of concerns typically addressed by commissions in reviewing transactions of this type. It is difficult to eliminate risks entirely; therefore commitments, limitations, and protections are necessary to ensure that the public will eventually see benefits from the merger that is at issue here.

Q. Please summarize Staff's position on the transaction as proposed by the applicants.

1 A. Staff believes that the transaction as structured will create a substantially increased risk of
2 impairment of utility financial status, and of preventing the utilities from providing safe,
3 reasonable, and adequate service. Staff does not believe that the transaction, as proposed
4 by the applicants, should be approved. Our analysis demonstrates that a number of risks
5 will arise from a transfer of ownership and control like that proposed here. Against those
6 risks, we do not see significant positive benefits for customers. The imposition of
7 conditions can serve to mitigate, but not to eliminate those risks. Therefore, the absence
8 of significant positive benefits to counter risks is problematic.
9
10 It oversimplifies things to search for a simple, mathematical equation that balances "pros"
11 and "cons" to produce either a certain minus sign (reflecting net harm) or a certain
12 positive sign or a "zero," that can be taken as proof positive of the lack of harm. Avoiding
13 such oversimplification takes on substantially magnified importance here. UniSource has
14 been engaged in a long-term "make-well" program that has taken place largely at this
15 Commission's direction, and certainly with its creditable and enduring patience.
16
17 A particular aversion by regulators to the uncertainties of change is prudent, and should
18 not be forsaken on the basis of small or even moderate changes in the potential or
19 possibilities for greater progress than has been demonstrated to date. Thinly supported,
20 and partially explained projections of improvement should not be taken as convincing
21 proof of future benefits in any case. They should actually produce significant concern
22 under the circumstances present here, which may be described as a long-term
23 rehabilitation of UniSource's financial health. Claims of no net harm or even of marginal
24 benefit to customers should meet substantial disfavor, if there is reason to believe that they

1 create new or increased risks of disruption to this rehabilitation effort, in which the
2 Commission, customers, and investors have all been participating.
3
4 Today's environment of low cost financing should not produce an assumption that good
5 times will continue indefinitely, for the purpose of analyzing post-merger outcomes. Nor
6 should one take lightly the inference, commented on by one important stakeholder, that
7 the desire to capture a healthy premium over current market price may foreshadow a crack
8 in the necessary commitment to debt reduction that remains and should remain a first
9 priority for UniSource for some time still to come.
10
11 **Q. Please summarize the reasons for taking these positions.**
12 A. **First**, there is an increase in leverage at the consolidated level, despite the increase in
13 equity as a percentage of total capitalization at the Tucson Electric Power Company
14 ("TEP") level. For an entity already leveraged so substantially as UniSource, this increase
15 considerably diminishes the ability to withstand financial stress imposed by market or
16 operating conditions. As proposed, the transaction does not contain protections against
17 the diminution of utility subsidiary equity in the event that it is needed to support finances
18 or operations of other elements of the family of entities that will exist upon completion of
19 the transaction proposed here.
20
21 **Second**, the strong need for providing cash flow to support debt payment creates a
22 significant concern about assuring that cash flow is so used. The transaction as structured
23 does not provide sufficient assurances that all free cash flow will be used to bring debt
24 levels down to a stated level that is acceptable to this Commission. We do acknowledge
25 that plans call for doing so. One can expect the lenders to exercise reasonable diligence in

1 protecting their interests in debt paydown. Nevertheless, it is appropriate for the
2 Commission to add its own requirements with respect to use of cash to be generated by the
3 utility and then transferred up in the structure of which it will remain the dominant part.
4
5 **Third** is the pressure, noted in Mr. Reiker's testimony, for leveraged buyouts to be
6 followed by strong actions to cut costs. The potential for turnover in the investment group
7 adds further to concerns about the potential that there will be too short-term a focus on
8 service-quality issues. The transaction as proposed contains no objective, enforceable
9 protections against reductions that are inappropriate to long-term maintenance of safe,
10 reliable, and adequate service. The transaction as structured does not contain an effective
11 method for ensuring continued service quality, either through the adoption of specific
12 retail performance standards, quantified minimum expenditure levels, a requirement for a
13 focused, independent post-transaction review of management and operations, or a
14 combination of these methods. The lack of such methods creates, in these circumstances,
15 an inappropriately increased risk of service-quality degradation.
16
17 **Fourth** is the absence of controls on additional investments that the resulting corporate
18 structure may make. The addition of new, potentially more risky operations, even if
19 funded fully through new equity alone, could impose additional pressure on utility capital
20 resources and operating expenses, in the event of less-than-anticipated performance by
21 those new operations. UniSource, either before or after the merger, is not in a position to
22 add risk by making investments in additional businesses. There should be strict limits on
23 the ability of the partnership to do so absent prior approval from this Commission.
24

Fifth is the lack of involvement that this Commission might have in the event of changes in control of Saguaro Utility Group, L.P. ("Partnership"), which would occupy the top-tier position in the structure after reorganization as proposed. Making changes in the general partner or changes in the controlling interests among the limited partners without the approval of this Commission creates risks that the strengths of the partners who seek to gain control over UniSource will turn into the liabilities of their successors. The nature and identity of the partners in this transaction received significant attention in their presentations to UniSource and in the applicants' statements to this Commission in these proceedings. The nature and identity of anyone to whom the partners may transfer their interests in the future should be of similar interest and concern. It should be made clear that approval of this transaction is contingent upon an enforceable commitment not to transfer, without prior approval of this Commission, ownership of the entity that forms the general partner or to transfer the interest of the Kohlberg Kravis Roberts ("KKR") -related or J. P. Morgan Partners ("JPM") - related entities in the partnership.

Sixth is the potential for conflicts of interest due to the particular business activities of the limited partners. Absent clear limits on and regular reporting of transactions between them and affiliates to the extent that utility costs are affected directly or indirectly, there are inappropriate risks of cross-subsidization at utility expense.

Seventh is the loss of outside oversight that will occur if there is no retention of a board with substantial outside membership at the utility level. There will be no assurance of such retention if this Commission should approve the restructuring as proposed. Staff understands, however, that there has been no decision by the new owners on retaining such a board. The failure to replace the outside directors lost through the reorganization,

1 by establishing a utility-level board or advisory committee, exacerbates the potential for a
2 loss of focus on meeting public-service responsibilities over the long term.
3
4 **Eighth** is the level of intrusion that the limited partners may have upon utility operations.
5 The ability of utility management to respond affirmatively, flexibly, and forcefully to
6 transient conditions can be unduly hampered by the approvals that must be secured from
7 the limited partners. It is unusual and cumbersome for a utility to require board-of-
8 director approval for some of the actions that require approval from the limited partners.
9 It is even more unusual and burdensome to require approval from owners, who are even
10 further removed from utility operations decisions. The potential for limited partner
11 involvement in details of utility operations creates an unacceptable potential for
12 operational intrusion by entities too far removed from operations and with no assured level
13 of utility operating experience or expertise.
14
15 **Ninth** is the question of access to books and records, and more broadly the need for
16 assuring continuing recognition of Commission oversight and authority. The applicants
17 generally commit to making records available, but the lack of firm commitments to full
18 access to all records related to matters directly and indirectly affecting utility operations is
19 of concern. Moreover, Staff remains in discussions with the new investors about access to
20 a number of projections material to assessing the reorganization. While significant
21 progress has been made, not all issues regarding access to information have been resolved.
22 It therefore remains premature to judge whether the remaining issues under discussion
23 evidence significant concerns. These concerns are about the degree to which this
24 Commission can expect the kind of prompt and full disclosure that is generally to be
25 expected from more traditionally structured utilities and holding companies.

Tenth is the translation of a series of the applicants' generalized statements about other matters (*e.g.*, headquarters location and community support) into commitments. If the Commission finds that the expectations created by these statements are material to approval of the transaction, then it should make them enforceable commitments. This is not because of concerns about the sincerity of statements of intent, but strictly because of the differences between intentions and commitments, particularly in light of the fact that future circumstances may differ from those existing when intentions were declared.

Q. Does this list of concerns merit denial by this Commission of the requested relief?

A. Staff recommends that the Commission not approve the transaction as proposed.

Q. Would the addition of certain conditions affect this opinion?

A. Yes; if the conditions that Staff discusses are agreed to, then the risks associated with the transaction will be significantly mitigated.

Q. Can you summarize what Staff intends by offering proposed conditions?

A. The applicants should be required to commit to certain conditions before the Commission considers approving the transaction. This testimony discusses at length the circumstances supporting the need for these conditions. The list of conditions we propose is by no means exhaustive. We will adjust it if necessary in our subsequent testimony filing.

Q. List the proposed conditions related to protecting the financial integrity of TEP and the other utility affiliates.

A. We recommend the following financial conditions:

- Maintenance of minimum utility equity capital ratios
- Attainment of targeted credit ratings improvements
- Separately negotiated and structured financings and financing arrangements for the utility operations
- Full segregation of utility funds in separate cash management systems
- No pledge of utility assets, financial support, or cash flow for other than utility benefit
- Protection from bankruptcy and insolvency of affiliates
- Prohibition on inter-company loans
- Protection of Commission oversight, authority and reporting requirements regarding financial matters.

Q. List the proposed conditions related to ensuring continued service quality and reliability.

A. The applicants should make specific commitments to ensure continued service quality and reliability. Conditions designed around specific customer-service and network-performance measures or minimum capital and O&M expenditure levels are beneficial. Development of such standards, however, may not be practicable in this proceeding. To that end, we recommend that the applicants agree to a management and operations audit, to begin within 18 months after closing, to determine if it has continued to make the capital and O&M expenditures needed to provide safe, efficient, and reliable service. Applicants should agree to fund not less than $400,000 of the costs of such an audit, to be performed by an auditor selected by the Commission and according to a scope and work plan established by Staff. Applicants should also acknowledge the Commission's intent to

consider the adoption of retail service quality standards applicable to them, and should agree that nothing in the approval of the merger should be read as limiting the ability of the Commission to apply such standards as may eventually be approved to their Arizona utilities.

Q. List the proposed conditions related to affiliate issues.

A. The applicants should agree to a broad interpretation of the term "affiliate," which should include any companies in which the general and limited partners (or their related entities) have an interest. UniSource should develop and submit for Commission approval an appropriate Code of Conduct and a Cost Allocation Manual governing the interactions of TEP, as well as UNS Gas and UNS Electric, with affiliates. These two documents should address such issues as: (a) allowable transactions and pricing for those transactions; (b) policies and procedures for shared services; (c) use of confidential customer information; (d) preferential access to services or assets; (e) required reporting for non-tariffed transactions and employee transfers; and (f) access to books and records.

The applicants should also provide justification for continuing any of the waivers to the Affiliated Interest Rules adopted in prior Commission orders, as well as for any additional waivers being sought.

Q. List the proposed conditions related to governance, oversight, and community presence.

A. We recommend the following conditions:

- UniSource will retain a utility-level board with substantial outside membership

- The new owners will commit to keeping the headquarters in Tucson indefinitely, and seek Commission approval before moving them
- There can be no change in the general partner and no material change in the limited partnership interests without Commission approval
- New owners will provide full access to all records regardless of the affiliate creating or possessing them, to the extent related to matters directly and indirectly affecting utility operations, including, without limitation, documents related to costs, to financing, to strategic and operational plans, and to governance
- Applicants will make firm commitments regarding community support

Q. List any other proposed conditions Staff considers appropriate.

A. Finally, we believe that the applicants should make firm commitments regarding the recovery of certain costs, specifically:

- New owners agree not to seek recovery of the Partnership costs of the merger transaction or the Partnership's post-merger operations
- None of the utilities may ever recover any portion of an acquisition premium or associated costs of the transaction from their customers.

Standards for Reviewing the Proposed Transaction

Q. What standards has Staff applied in reviewing the proposed transaction?

A. Staff has examined whether this transaction is in the public interest. As part of that examination, Staff considered R14-2-803, which states that the Commission may reject a proposal for reorganization if it determines that it would impair the financial status of the public utility company, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable, and adequate

service. These standards are similar to those that state commissions have considered when evaluating other similar transactions.

As discussed earlier, Staff believes that this standard can be summarily reduced to a "no net harm" test. Terms like "impair the financial status," "prevent," and "impair...service" need to be applied not against firm prognostications about what will happen in an uncertain future, but against what can happen. In this case, they also need to be applied in the context of a long-term, "make-well" program, which should produce an aversion to changes not shown to produce clear likely benefits (at acceptable risks) in moving the goals of that program forward. Staff likens this statement of the standard to the different view that a physician would take of the regimen appropriate for an otherwise typical and healthy patient, in comparison to one who has not been and who is not yet either.

This is not to say that expected benefits need to be either certain or profound. They simply need to be discernible and likely enough to overcome a prudent reluctance to change course before UniSource (more particularly TEP, as influenced by UniSource) reaches a position where less caution becomes warranted. Moreover, it should be clear that a substantial premium to shareowners and an opportunity for significantly higher returns to investors (through the effects of double leveraging) does not counterbalance significant new or added risks or detriments to customers. There is certainly a public interest in promoting such premiums or opportunities where they can convincingly be shown to come as part of a transaction that produces benefits to all stakeholders. There is not, however, a public interest in promoting them when it is at customer risk. The same is true when there has not been a convincing demonstration that benefits exceeding new or increased risks will come to customers. Absent this positive demonstration, it is Staff's

1 and Liberty's position that the uncertainties associated with making a change in the face of
2 slow, but steady, progress support a conclusion that the applicable standard has not been
3 met. Quite simply, the reason is because UniSource and its utilities already have so little
4 (compared with peers) ability to withstand stress.
5

6 ## Other, Similar Transactions

7 **Q. How does this transaction compare with those that other commissions have examined**
8 **recently?**

9 A. There are few closely comparable transactions. This is not a traditional reorganization;
10 *i.e.*, one involving a merger of existing utilities or of utility holding companies. The
11 proposed reorganization involves the acquisition of UniSource by a private equity
12 partnership. In recent years, Texas-New Mexico Power and MidAmerican Energy were
13 both acquired by private investors. There have been other non-traditional transactions,
14 such as Enron's acquisition of Portland General Electric (PGE), Scottish Power's
15 acquisition of Pacific Power and Light, AES's acquisition of Cilcorp and IPALCO,
16 Ameren's purchase of Cilcorp from AES, and CalEnergy's merger with MidAmerican.
17 The last was the first merger of an independent power producer and a utility.
18

19 **Q. Have any of the proposed investors recently been involved in utility-related**
20 **transactions?**

21 A. Yes. In 2000, KKR made a $550 million investment in DPL Inc., the parent of Dayton
22 Power and Light, representing an interest of approximately 20 percent. In 2002, KKR
23 joined with another private investment firm and the State of Michigan to purchase

International Transmission Company, the transmission subsidiary of Detroit Edison. Neither of these transactions required approval by state commissions.

Q. Have the applicants provided an analysis of comparable transactions?

A. Yes, but it was not one designed to describe what actions commissions have taken in reviewing transactions and in imposing conditions on them. In their special proxy statement, the applicants discussed Morgan Stanley's review of selected precedent transactions, performed as part of the firm's fairness analysis. That analysis focused on comparing ratios of the prices paid for common stock to forecasted earnings and book value, for example. The Morgan Stanley analysis focused primarily on the interests of UniSource stockholders, not on the much fuller range of public issues that this Commission must consider. In its analysis, Morgan Stanley compared the proposed transaction to: (1) AES Corporation's acquisition of IPALCO; (2) AES Corporation's acquisition of Cilcorp; (3) PowerGen PLC's acquisition of LG&E Energy; (4) SW Acquisition L.P.'s acquisition of TNP Enterprises; (5) National Grid's acquisition of New England Electric System; and (6) CalEnergy Company's acquisition of MidAmerican Energy Holdings. Morgan Stanley observed that none of its precedent transactions was identical to the proposed UniSource reorganization.

Q. On what areas have other commissions focused in reviewing transactions?

A. Each case has been different, but the commissions examining them have typically considered whether the transaction would negatively affect the following:

- Customer or the public interest, including rates
- Utility ability to attract capital on reasonable terms and to maintain a reasonable capital structure

- Utility ability to provide safe, reasonable, and adequate service
- Commission access to books, records, or other information related to the utility and its affiliates.

Applicable laws in each state guide public service commission examinations of proposed mergers. In the Texas-New Mexico Power case, for example, the Texas Commission had to consider whether the merger was consistent with the public interest as defined by the Texas public utility code.

Q. Briefly describe the transactions reviewed by the Oregon Commission.

A. The Oregon Commission reviewed two separate transactions: Enron's acquisition of PGE and Scottish Power's acquisition of Pacificorp. Oregon law provided that the commission should determine whether approval would "serve the public utility's customers in the public interest." In both cases, the utilities argued that this meant a "no net harm" standard, while other parties argued that this meant a "net benefits" standard. In both cases, the Oregon Commission found that it did not need to choose between the two standards, because benefits to PGE and Pacificorp customers contained in their respective stipulation agreements were sufficient to satisfy a no-harm standard and to provide reasonable assurances that there would be positive net benefits.

Q. What standards did the Illinois Commission consider in the Ameren acquisition of Cilcorp?

A. That commission's review was governed by relevant sections of the Illinois Public Utilities Act dealing with reorganizations. The commission could not approve any reorganization found to adversely affect the utility's ability to perform its duties under the

1 act. Under the act, the commission was required to make a series of findings in order to
2 approve the reorganization:

3 - The proposed reorganization would not diminish the utility's ability to provide
4 adequate, reliable, efficient, safe, and least-cost public utility service
5 - The proposed reorganization would not result in the unjustified subsidization of
6 non-utility activities by the utility or its customers
7 - Costs and facilities would be fairly and reasonably allocated between utility and
8 non-utility activities in such a manner that the commission would be able to
9 identify those costs and facilities that are properly included by the utility for
10 ratemaking purposes
11 - The proposed reorganization would not significantly impair the utility's ability to
12 raise necessary capital on reasonable terms or to maintain a reasonable capital
13 structure
14 - The utility would remain subject to all applicable laws, regulations, rules,
15 decisions, and policies governing the regulation of Illinois public utilities
16 - The proposed reorganization would not likely have a significant adverse effect on
17 competition in those markets over which the commission has jurisdiction
18 - The proposed reorganization would not likely result in any adverse rate impacts on
19 retail customers

20

21 **Q. What standards did the Iowa Board consider in its review of the acquisition of**
22 **MidAmerican by private investors?**

23 A. As noted by the Board order on MidAmerican, the Iowa Code lists the following factors as
24 those that the Board may consider in its review of a reorganization plan:

- Whether the Board would have reasonable access to books, records, documents, and other information relating to the public utility or any of its affiliates
- Whether the public utility's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, would be impaired
- Whether the ability of the public utility to provide safe, reasonable, and adequate service would be impaired
- Whether customers would be detrimentally affected
- Whether the public interest would be detrimentally affected

Q. Did other commissions generally impose any conditions on these transactions?

A. Yes. Utilities made commitments about, among other things, merger savings, financial conditions regarding investment ratings, dividends and capital structure, affiliate relationships, protection of commission oversight and authority, and recoverability of transactions costs, including acquisition premiums.

Q. Please provide an overview of the two recent transactions that involved private investors.

A. In 2000, the Texas Commission approved the transfer of control of TNP Enterprises ("TNP"), the parent of Texas-New Mexico Power ("TNMP"), to a private investor group, ST Acquisition Corporation. The transaction produced a change in ownership of TNP Enterprises stock, but combined no utility operations.

In 2000, three investors, including Berkshire Hathaway, purchased all the equity shares in MidAmerican Energy Holdings, the parent of MidAmerican Energy. A year earlier, CalEnergy had merged with MidAmerican.

Q. Can you discuss some of the issues addressed in the TNMP transaction?

A. The parties in that case entered into a stipulation agreement, which set forth 13 specific commitments made by TNMP. During that case, the ratepayer advocate and other parties contended that an investment grade bond rating was material to a public interest finding, and that the financial restrictions and conditions in the stipulation should assist TNMP in obtaining an investment grade bond rating.

In that case, the commission found additional guarantees about cost shifting, cross subsidies, or discriminatory behavior among affiliates of the merged company to be unnecessary. The reason was two-fold: there already existed affiliate rules and codes of conduct, and there was state legislation concerning affiliates.

Q. What conditions did the parties agree to in that case?

A. The stipulation agreement in that case included TNP and TNMP commitments in the following areas:

- Quality of service guarantees in the areas of customer service, new service installations, and electric reliability
- Employee safety guarantees
- High priority placed on investment grade bond ratings
- Limits on leverage ratios, with limitations on dividends if ratios were exceeded
- Specified limitations on dividends, including commitments of maintenance expenses and capital expenditures
- Protection from increases in the cost of capital
- No merger transaction costs charged to TNMP

- Protection from bankruptcy and insolvency of TNP
- Limitation on TNMP's investments to those involved with basic utility services
- Protection of commission oversight and authority
- Notification of TNMP credit downgrades and provision of TNP financial statements
- Stranded-cost mitigation

Q. Please discuss some of the issues that the Iowa Board addressed regarding the MidAmerican transaction.

A. The Iowa Utilities Board stated that the reorganization consisted of reducing the number and changing the identity of the shareholders of MidAmerican's parent. In the prior CalEnergy merger, the new owner had made commitments on, among other things, maintenance of investment-grade ratings and an adequate capital structure for MidAmerican Energy, affiliate relationships, affiliate debt, and non-recourse financing. The new investor group reaffirmed the commitments made during the prior transactions. The Board used this affirmation as a basis for determining that the merger should be allowed to go forward. Therefore, the Board applied no substantive new conditions in the second reorganization.

Q. Were conditions placed on utilities in other transactions that you mentioned earlier?

A. Generally, yes. The Oregon commission's approval of the Enron merger with PGE in 1997 was based on 22 conditions set forth in a stipulation agreement, as well as roughly $140 million in guaranteed monetary benefits for customers. In granting its approval for the Scottish Power acquisition in 1999, the Oregon commission adopted 24 merger

conditions in five separate stipulations. In addition, Scottish Power agreed to provide roughly $50 million in rate credits over four years.

AES purchased IPALCO in a share-exchange transaction in 1999. AES became an exempt holding company. One term of the IPALCO acquisition was that AES divest Cilcorp, the parent of Central Illinois Light ("CILCO"). The AES purchase of IPALCO was subject to SEC and FERC, rather than state commission, approval. The subsequent sale by AES of Cilcorp to Ameren in 2002 was, however, subject to approval by the Illinois commission. At that time, Ameren was already the parent of two regulated utility subsidiaries: AmerenCIPS (formerly Central Illinois Power) and AmerenUE (formerly Union Electric). The applicants ultimately proposed 25 "conditions of approval" to minimize the number of contested issues. These conditions included non-recovery of transaction and transition expenses and limits on Ameren's purchases of new capacity in CILCO territory.

Q. What were some of the conditions in the Enron merger?

A. Some of the conditions of the stipulation agreement were:

- Ability of commission to determine reasonableness of allocation factors used to assign costs to PGE
- Ability to audit accounts of Enron and unregulated subsidiaries that formed the basis of charges to PGE
- Commission access to books and records pertaining to transactions between PGE and all affiliated interests
- Exclusion from PGE accounts of all costs of the merger, including transaction costs

- Separate PGE debt and preferred stock ratings
- Commission approval for any PGE distribution to Enron that would cause PGE's equity capital to fall below 48 percent of total PGE capital
- No increase to allowed return on common equity and other costs of capital as a result of the merger
- Notification to commission by Enron of significant transfer of PGE's retained earnings or of intention to declare a special cash dividend
- PGE adoption of specific service-quality performance measures
- No preferential treatment by PGE of affiliates with respect to excess natural gas or power assets
- No transfer of customer information to affiliates and non-affiliates without customer permission
- PGE and Enron agreement to comply with commission requirements, including those on transactions with affiliates.

Q. What generally is Staff's view about the need for conditions of these types?

A. Staff believes that they are necessary for assuring that mergers, acquisitions, reorganizations, and other forms of changes-in-control of public utilities do not create a material risk of:

- Financial harm in the form of difficulty or undue expense in securing capital efficiently and economically
- Adverse consequences to utility operations from a failure to insulate utility finances from those of affiliates
- Decline in service quality, reliability, and adequacy

- Reduced access to information at the holding-company level and all levels below with respect to information that will allow the commission to continue to monitor conditions and take actions before potential harm becomes actual harm
- Cross-subsidization by utility operations of non-utility affiliates
- The imposition of significant added merger-transaction costs or holding company-related costs on utility operations.

Q. Why does Staff speak in terms of risks, as opposed to actual results?

A. Experience shows that even apparently stable, well-structured utility operations can become troubled, sometimes through unforeseen difficulties in the utility sector. Unfortunately, and all too often, the failure of non-utility investments and activities to perform to expectations and financial weakness at the holding company level underlie such troubles. Moreover, UniSource does not begin from a strong position. The ability to withstand future reverses at the utility or holding-company level, whether from utility or non-utility causes, is correspondingly weaker. Slow but reasonably steady progress is being made in restoring TEP to a sounder financial condition. It is against that pattern of progress and its prospects for continuation that this Commission should measure the alternative that this proposed reorganization presents.

Were TEP in a stronger position, perhaps more tolerance for future risks might be in order. Whether that is true or not, however, is academic. The real issue is whether the transaction as structured increases risks. If it does, the next question becomes whether the Commission should accept that risk, should impose conditions to mitigate it, or should simply deny the relief requested. The view of Staff at present is that the Commission should not approve the transaction as currently proposed.

The Need to Turn Applicant Commitments into Enforceable Conditions

Q. What significance should the Commission attach to statements of intent with respect to management and operations after approval may be granted?

A. Such statements provide an important source of what ownership and management intend, based upon their current expectations about the future. However, we must recognize that statements of intent are generally meant, whether explicitly stated or not, to apply in the event that future circumstances conform to current expectations about them. Even where such statements take the form of contractual commitments between private parties, there remains substantial uncertainty about how the future will affect them. Agreements can be amended, are often amended, and often should be amended when future circumstances bring surprises.

Commissions have the power and in many cases the need to require more than statements of intent or private contracts on occasions such as this one. The Commission should make certain that all statements of intent deemed material to any granting of the relief requested be made enforceable conditions on such a grant. This approach will obviate the need for future debate and potential disagreement about the firmness of current statements of intent or commitment. It will also, in some respects at least, prove material to assuring that important protections have effect.

Q. Please offer an example of a case where applying a Commission condition will have greater effect than a private commitment.

A. The ring-fencing provisions addressed in this testimony provide a good example of the difference between private commitments and public obligations. Such provisions have

much less impact on rating agencies when they arise as a matter of private, and therefore amendable, agreement. When, however, they arise through Commission order, and take a Commission order to change, they are much more likely to be considered substantial.

It is also important to establish with great clarity the specific requirements associated with a transfer of control such as the one at issue here. The line between what regulators expect and what they more specifically require should be clear and distinct. Leaving for consideration in later proceedings questions of interpretation, and, in the worst case, dispute about what the Commission intended to require, as opposed to what it merely hoped or expected to occur is a course fraught with peril.

Financial Conditions on Other Transactions

Q. What types of financial conditions have utilities and acquiring companies agreed to in connection with reorganization or merger?

A. Some of the more common conditions include limitations on dividends, maintenance of separate debt ratings for the utility, financial covenants, and minimum equity or maximum debt ratios.

Q. What types of financial conditions did the Texas commission secure in the TNMP transaction?

A. The stipulation in that case included several conditions geared to maintaining TNMP's financial integrity. They included:

- TNMP would strive to maintain investment-grade bond ratings on its senior debt obligations.
- TNMP agreed to maintain a 65 percent maximum leverage ratio (35 percent minimum equity) through the end of 2001 and a 70 percent maximum leverage ratio from 2002 through 2004 For the 12 months ending September 2000, TNMP would limit dividends to TNP to no more than cash flow from operations from the preceding twelve-month period less cash flow from investing for the same period. TNMP would adopt the same limitation for all quarterly periods thereafter through 2004. Violations of this condition produce a penalty of $5,000 per day for each day in violation.
- TNMP committed to expend funds to maintain its T&D system in an amount of at least $8 million annually in maintenance and $23 million annually in capital expenditures through 2004. TNMP also agreed to expend at least $3 million annually on maintenance of its generation facilities for so long as it owned them.
- TNMP committed that any potential increase in the cost of capital resulting from the transaction would not have a negative impact on TNMP's customers through 2004. Any projected financing included in its 2002 test year would be assumed to have been at investment grade rates, regardless of TNMP's actual bond ratings.
- TNP debt was required to include separate covenants that would remain in effect as long as the rated indebtedness of TNMP should remain outstanding, or until January 2004.

Q. **Please describe these covenants in more detail.**

A. These covenants provided that:

- TNP and TNMP are being operated as separate corporate and legal entities

- The lenders agreeing to make loans would rely solely on the creditworthiness of TNP based on the assets owned by it
- Loan repayment would be made solely from the assets of TNP and not from any assets of TNMP
- There would be no steps taken 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 in respect of TNMP or any of its liabilities
- TNP agrees that any future material indebtedness would comply with the foregoing restrictions

Q. What types of financial conditions did the Oregon commission impose in the Enron merger?

A. The stipulation in that case contained a number of financial conditions to ensure that Enron did not weaken PGE's financial condition:

- PGE would maintain its own long-term debt ratings and preferred stock ratings for as long as it has preferred stock outstanding
- PGE would not make any distribution to Enron that would cause PGE's equity capital to fall below 48 percent of the total PGE capital absent commission approval
- Unless otherwise unlawful, Enron would notify the commission of:
    - Intention to transfer more than 5 percent of PGE's retained earnings to Enron over a six-month period, at least 60 days before such a transfer begins
    - Intention to declare a special cash dividend from PGE, at least 30 days before declaring such a dividend

  - o The most recent quarterly common stock cash dividend payment from PGE, within 30 days after declaring such dividend.
- Enron would provide commission access to information provided to the financial community
- PGE customers would be held harmless in the event that the merger between Enron and PGE should result in a higher revenue requirement for PGE than would exist in the absence of the merger.

Q. What types of financial conditions did the Oregon commission impose in the Scottish Power acquisition of Pacificorp?

A. Basically, the applicants agreed that Pacificorp would maintain a minimum common equity ratio, and would not seek a higher cost of capital than would have been authorized if on its own. They also agreed to maintain separate debt and preferred stock ratings and to provide notice of certain distributions from Pacificorp to Scottish Power.

Q. Did the applicants in the Ameren/Cilcorp transaction agree to any specific financial conditions?

A. Yes. Ameren purchased Cilcorp from AES, which was forced to divest it as a condition of AES's purchase of IPALCO. One of the specific concerns of the staff in that transaction related to Cilcorp's generation assets. CILCO had transferred its generation assets to Central Illinois Generation Inc. ("CIGI"), a wholly-owned but unregulated subsidiary. Ameren had requested: (a) approval from the SEC for CIGI to issue up to $500 million in additional long-term debt, and (b) authorization to refinance the $475 million in debt that Cilcorp incurred when AES acquired it. Because GIGI was a wholly owned subsidiary of CILCO, added CIGI debt would increase CIGI's cash-flow risk. The additional GIGI risk

in turn would increase CILCO's risk, and hinder its ability to support Cilcorp's debt. In the event CIGI defaulted on the debt, CILCO could be held liable, unless measures were taken to insulate CILCO from CIGI. Ultimately, the commission staff found that the merger conditions would mitigate these risks. One of the conditions that Ameren agreed to was to seek Illinois Commerce Commission ("ICC") approval whenever it sought to transfer tax-exempt debt to an affiliate or to guarantee the performance of any affiliate's obligations.

Q. Were conditions imposed by the commission on the acquisition of MidAmerican by private investors?

A. The Iowa Board did not impose any new conditions when Teton, a group of private investors that included Warren Buffet's Berkshire Hathaway, purchased MidAmerican Energy. MidAmerican had merged with CalEnergy, an independent power producer a year earlier. CalEnergy and MidAmerican agreed to certain commitments relating to maintenance of an investment-grade rating, an adequate capital structure for MidAmerican Energy, affiliate debt, non-recourse financing, and cash infusions by the parent, MidAmerican Holdings. The new investor group reaffirmed these commitments. The Board noted that the reorganization by Teton increased the stockholder equity of MidAmerican Holdings, which reduced the financial risk of the consolidated company. Ratings agencies had also reacted positively to the reorganization.

Reliability Conditions in Prior Transactions

Q. How common are reliability and service quality commitments by utilities in connection with reorganizations or mergers?

1 A. They are often made. In a number of cases these conditions have been extensive and
2 detailed. Commissions have recognized that one way for acquiring companies to increase
3 cash flow from their utility subsidiaries after a merger is to cut operations and
4 maintenance ("O&M") expenditures and capital investments in utility facilities.
5 Commissions have used reliability and service-quality commitments as a way to ensure
6 that new owners do not allow service quality and network performance to degrade as a
7 result of post-merger cost cutting to secure projected synergies or return levels.
8
9 **Q. What are some examples of these reliability and service quality commitments?**
10 A. In the TNP case, the applicants made extensive quality-of-service guarantees. The Texas
11 commission relied upon the guarantees that TNMP agreed to in the stipulation in
12 concluding that the merger would not result in a decline in TNMP's service. TNMP
13 agreed to specific customer-service conditions, such as maintaining T&D and customer
14 service employee staffing levels at local offices, timely service turn-ons and upgrades,
15 timely replacement of street and security lights, and answer times at customer-service call
16 centers. TNMP also agreed to specific, system reliability conditions. The commitments
17 included credits to customers for failure to meet specified standards. In addition, TNMP
18 agreed to an outside audit every two years to determine that the performance standards
19 have been implemented.
20
21 **Q. Can you discuss some examples of TNMP's customer service conditions?**
22 A. Yes. As already noted, these are quite specific, and were set out in a separate exhibit to
23 the stipulation in that case. Staff can provide some examples. On a quarterly basis, 90
24 percent of the time, TNMP's average answer time for customer calls cannot exceed 60
25 seconds. If the company should fail to meet the standard, it must rebate, via bill credit,

$20 for each identifiable customer who does not receive service within the standard. For customers that the company cannot identify, it must contribute $20 to a fund to benefit low-income customers.

The company also must within 24 hours complete 95 percent of new-service installations that do not require construction or facilities. The period runs from the time when the customer's location is ready for service, and all tariff conditions have been met. The stipulation sets out similar conditions for those new installations that do require construction and for service upgrades. If the company fails the standard, it must provide a $40 bill credit to each customer not connected within the given timeframe.

Q. Can you discuss some of the TNMP electric reliability conditions?

A. The TNMP service area is divided into seven separate business units. The company must calculate a System Average Interruption Frequency Index ("SAIFI") and System Average Interruption Duration Index ("SAIDI") for each business unit. TNMP agreed that:

- No distribution feeder within a business unit will sustain a SAIFI or SAIDI that is among the highest (worst) 10 percent of the unit's feeders for any two consecutive reporting periods
- No distribution feeder within a business unit will sustain a SAIFI or SAIDI for a reporting year that is more than 300 percent greater than the system average of all feeders in that same unit for any two consecutive reporting periods
- No business unit will exceed the 3-year system-wide SAIFI or SAIDI standard by more than 5 percent

TNMP agreed to make payments to customers for failure to meet these reliability standards, up to a maximum of $500,000 per year. For example, TNMP must pay a service reliability credit of $20 to each customer on all feeders within a business unit that fails to meet the 10 percent worst-feeder distribution standard.

Q. Please discuss examples of these reliability and service quality commitments in other transactions.

A. In the Enron merger stipulation, PGE agreed to implement a service-quality performance program. PGE became subject to revenue-requirements reductions should it not meet certain performance targets. The commission order stated that this condition protected against potential harm from service-quality reduction.

The applicants in the Scottish Power acquisition of Pacific Power and Light entered into an agreement with commission staff regarding performance standards and customer guarantees. The applicants agreed to adopt certain network-performance standards and to extend existing service-quality measurements. The agreement provided for revenue-requirements reductions for poor performance. The utility agreed to pay a customer penalty of $50 for failure to meet the following customer service guarantees:

- Restoration of power within 24 hours
- Keeping mutually agreed appointments
- Activation of power supply within 24 hours when no construction is required and government requirements are met
- Providing estimates for new power supplies within 5 business days when no network changes are needed, and within 15 business days when network changes are needed

- Providing customers with 2 days' notice of planned power interruptions
- Initiating an investigation within 7 days or providing a written explanation within 5 days for power quality complaints

Books and Records Conditions in Other Transactions

Q. Have future commission authority and commission access to books and records been a concern in connection with reorganizations or mergers?

A. Yes; our review showed this to be a common area of concern. Such access is especially important here. The UniSource utilities have rate cases scheduled. The new owners will not be subject to all the same disclosure requirements that apply to publicly held companies. The Commission's ability to properly set rates will hinge on its ability to place a high level of confidence in the trustworthiness of the numbers on which it will rely. The Commission also must have full access to financial information appropriate for assuring that there is continued, steady progress toward long-term improvement in financial standing. The Commission also needs to assure itself that the introduction of entities in very competitive businesses and with substantial energy interests across the country does not reduce access to information that directly and indirectly concerns utility structure, management, plans, operations, and results.

These needs require that that there be no barriers added to Commission and stakeholder access to information, including but not limited to accounts and the records that support them. In particular, there should be no increased difficulty (by reason of refusal or delay) in securing access to all affiliate records that relate to activities and transactions that directly or indirectly affect utility cost of service, financial condition, and compliance with all public requirements and conditions imposed as a result of any merger approval.

Q. What were some of the conditions regarding future commission authority or books and records in the Scottish Power acquisition of Pacificorp?

A. In its order on the Scottish Power acquisition, the Oregon commission pointed out that risks common to many merger transactions are:

- Important books and records of the regulated company may be kept outside the commission's jurisdiction
- The commission may be denied access to important books and records of a parent or affiliate of the regulated company
- Transactions with affiliates or cost allocations may be conducted in a way that results in a cross-subsidization by the customers of the regulated utility.

In the case of the Scottish Power acquisition, the risks had the potential to be exacerbated because the acquiring company was based in a foreign country. In other words, the merger was different from one involving two entities, each of which has significant domestic utility operations. In that merger of like entities, which is not the case here, it is more likely to see reasonably common approaches to disclosure – approaches developed by companies used to the kinds of inquiries that utility regulators make. With the imposition of certain merger conditions, the commission found itself comfortable that it would continue to have essentially the same regulatory oversight over PacifiCorp that it would have absent the merger.

The commission relied upon the merger conditions to determine that the potential problems regarding access to books and records, affiliate-transactions, and cost-allocation issues were adequately addressed. PacifiCorp was required to maintain its own

accounting system separate from those of Scottish Power, and was required to keep all of its financial books and records at its headquarters in Portland, Oregon. Both PacifiCorp and Scottish Power were required to comply with all commission requirements regarding affiliated interest transactions, and PacifiCorp was required to file detailed semi-annual reports regarding such transactions. The commission was to have access to records of Scottish Power pertaining to transactions between PacifiCorp and all of its affiliated interests, and the commission affirmed its authority to audit the Scottish Power (and non-utility subsidiary) accounting records forming the bases for charges to PacifiCorp. Scottish Power and Pacificorp also agreed to waive in future proceedings any claim that the commission's authority over affiliated interest transactions is preempted by the Public Utility Holding Company Act ("PUHCA") or *Ohio v. The Federal Energy Regulatory Commission ("FERC").*

Q. What types of conditions did the applicants agree to in the Enron merger?

A. Three of the conditions in the stipulation in that case were put in place to supplement the commission's statutes and rules with respect to access to information and review of inter-corporate transactions that result in direct charges or cost allocations. These three conditions were:

- To determine the reasonableness of allocation factors used by Enron to assign costs to PGE and amounts subject to allocation or direct charges, the commission or its agents may audit the Enron and subsidiary accounts that form the bases for charges to PGE. Enron agreed to cooperate fully with such commission audits.
- Enron and PGE must provide the commission access to all books of account, as well as all documents, data and records of their affiliated interests that pertain to transactions between PGE and all its affiliated interests.

- PGE must maintain its own accounting system, separate from Enron's accounting system.

The companies also agreed to more frequent and expanded reporting of affiliate transactions, as well as a direct prohibition on allocations or direct charges from Enron to PGE without commission approval.

Q. What were some of the conditions regarding future commission authority or books and records in the TNMP acquisition?

A. The stipulation in the acquisition of TNMP by a private partnership included commitments on regulatory oversight and authority. TNMP agreed that it would not assert FERC pre-emption with respect to commission regulatory authority over rates and services provided to retail customers. Should TNMP cease to be required to make SEC filings, it must provide annual audited financial statements to the commission, as well as a FERC Form 1.

Q. What were some of the conditions regarding future commission authority in the Ameren acquisition of Cilcorp?

A. One of the conditions of the Ameren acquisition of Cilcorp was that the utility would not argue in any proceeding or on appeal of any ICC order that the ICC lacks the authority to adopt an appropriate adjustment to the cost of service of one of more of the Ameren utilities to reflect any adverse effects of the activities or circumstances of any unregulated or non-utility affiliate, including any adverse effect of such on the Ameren utilities' credit ratings.

The company also agreed to include in any contracts, agreements, tariffs, or arrangements made between CILCO and any affiliates and filed with the SEC or FERC language providing that it would not seek to overturn or reverse a decision or order of the ICC that pertains to recovery, disallowance, deferral or ratemaking treatment of any expense, charge, cost, or allocation incurred or accrued by CILCO on the basis that it had otherwise been approved by the SEC or FERC.

Miscellaneous Conditions in Other Transactions

Q. In addition to the financial, service quality, and commission authority and access issues, what other types of conditions have commissions secured in reorganization or merger proceedings?

A. Most stipulations in these cases include language about the non-recoverability of acquisition premiums, merger transaction costs, or merger transition costs from retail customers. Those relating to the TNMP, Enron, Pacificorp, MidAmerican, and Cilcorp transactions included such language, for example. Some, for example the TNMP stipulation, contain guarantees regarding employment levels or employee safety. Others, such as those from the Enron acquisition of PGE and the Scottish Power acquisition of Pacificorp, contain specific commitments on merger savings.

Financial Issues

Q. What is the current financial status of TEP and UniSource, and how will the proposed leveraged acquisition by the Partnership affect them?

A. UniSource and TEP continue to find themselves in a financial condition that must be described as weak. TEP's corporate credit rating currently is "BB" with Standard and Poors' and "Ba3" with Moody's, or two and three ratings levels, respectively, below the

lowest investment grade ratings. (See direct testimony of Joel M. Reiker. Exhibit JMR-10.) TEP debt has been rated below investment grade for an extended period of time.

It is unusual to find regulated utilities that show TEP's sustained lack of financial strength, and whose credit rating is at such speculative levels. Such financial weakness creates a barrier to the acquisition of capital at economic rates, and does not provide sufficient confidence regarding utility access to capital during tight credit periods. A utility regulatory commission should consider weak financial indicators and speculative credit ratings as a significant problem for a utility whose rates and service it regulates. Staff also believes that the acquisition as proposed here will not materially improve TEP's substandard financial position.

Q. Why are TEP and UniSource in such poor financial condition?

A. TEP has been in poor financial shape since the 1980s, originally as a result of building excess electric generating capacity and contracting for high-priced purchased power, whose costs it could not fully recover in rates. In 1989, a key power sales contract with San Diego Gas and Electric expired, leaving TEP with substantial excess generating capacity, for which it could not recover costs. In addition, TEP also diversified into non-utility areas in the 1980s. These ventures included car leasing, real estate, security investments, hotels and motels. These diversified investments also caused financial problems for TEP in the late 1980s and early 1990s.

1 TEP was not able to pay all of its creditors and vendors. Certain creditors filed an
2 involuntary petition for Chapter 11 bankruptcy in 1991. Following an extensive
3 reorganization of TEP's financing and contractual obligations and interim rate increases,
4 this Commission approved the Company's restructuring in 1992. The Commission said in
5 its Decision No. 58024, that "clearly the financial collapse of this once proud company
6 resulted from TEP's management imprudence and abuses of the 1980s."
7
8 TEP's recovery from this financial crisis did not go smoothly after 1992, however. TEP
9 requested that it be allowed to form a holding company in 1997. The record in this
10 proceeding notes that TEP had only 13 percent common equity in its capital structure, and
11 that its bonds were rated at speculative levels as of the summer of 1997. The Commission
12 noted that the average equity ratio for the electric utility industry at that time was 47
13 percent. In the six and one-half years since the 1997 holding company approval, TEP has
14 been able to increase its equity ratio to about 25 percent. However, TEP has never come
15 close to regaining financial strength commensurate with its peers. It has experienced an
16 extraordinarily long period of operation under financial conditions that are anomalous in
17 the industry.
18
19 **Q. Have there been plans for restoring TEP's financial health before the acquisition**
20 **proposal?**
21 A. Yes. This Commission's Order approving formation of the UniSource holding company
22 in 1997 placed a number of conditions on TEP and UniSource. Some of those conditions

1 had the goal of improving TEP's financial strength. For example, 60 percent of the
2 proceeds of equity sales by UniSource and one percent of the net income of TEP's
3 affiliated "sister companies" over the ensuing five years were to be used to increase TEP's
4 equity or to reduce its debt. TEP's dividends were restricted to 75 percent of its net
5 income until the TEP equity ratio reached 37.5 percent of its capital structure. If TEP did
6 not reach the targeted 37.5 percent level by the end of 2001, the Commission had the
7 option of reducing TEP's rates to reflect the lower level of common equity.
8
9 This Commission's 1999 electric restructuring and stranded cost Order for TEP reduced
10 the equity sales proceeds percentage earmarked for TEP to 30 percent, and extended the
11 TEP dividend restriction until the Company's equity ratio should reach 37.5 percent. The
12 Commission's 2003 Order approving UniSource's acquisition of Citizens
13 Communications' ("Citizens") Arizona electric and gas businesses extended this dividend
14 restriction until TEP should reach 40 percent equity. The same dividend restriction was
15 established for the acquired utility businesses.
16
17 TEP has not approached established equity capital targets since this Commission created
18 them in 1997. TEP's current equity ratio, as measured for the Commission's ratemaking
19 purposes, is about 25 percent.
20
21
22 **Q. Do TEP's current financial strength and credit ratings allow for the effective**
23 **financing of utility operations?**

1 A. No. TEP's only financing activity in the several years preceding the acquisition proposal
2 being addressed in these proceedings has consisted of the general credit facility of the
3 utility. Versions of this facility have been arranged in 1992, 1997, 2002, and most
4 recently in March 2004. TEP's credit facility includes a $60 million revolving line of
5 credit for working capital purposes and about $340 million in financial backing that permit
6 TEP to maintain its variable-rate debt instruments.
7
8 The November 2002 version of the TEP credit facility was the last financing arranged by
9 TEP prior to the leveraged buyout ("LBO") proposal. The interest rates on the revolving
10 line of credit were substantially above what could have been anticipated by a financially
11 healthy utility. Both the interest rates and financial backing rates for TEP are exceedingly
12 high for a utility, and reflect TEP's weak financial condition.
13
14 **Q. How would Staff describe the financial market conditions of the past several years**
15 **and how does Staff believe that changes in the market would affect TEP?**
16 A. The past several years have been quite favorable for raising capital, even for financially
17 weak companies such as TEP. In such favorable financial markets, TEP has been able to
18 maintain its revolving line of credit and variable-rate debt facilities, albeit at relatively
19 higher costs than healthy utilities pay.
20
21 However, the financial markets do not always remain so hospitable. When capital markets
22 occasionally contract in what is commonly called a "credit crunch," potential lenders
23 increasingly leave the market or lend money only to financially strong companies. This
24 "flight to quality" makes raising capital for financially weaker companies at the least more
25 difficult, if not impossible. The critical public-service nature of the electric and gas utility

1 businesses makes the ability to get access to capital for needed utility expenditures critical
2 to maintaining safe, adequate, and reliable service. It is not prudent to expose a utility
3 long term to the risk of being unable to acquire needed capital in difficult financial
4 markets.
5
6 **Q. Does the acquisition at issue here improve the financial standing of TEP, as**
7 **represented in the testimony of Mr. Pignatelli?**
8 A. We do not see convincing indications that TEP's standing would improve on an overall
9 basis. Moreover, at least one rating agency has raised the possibility of the opposite
10 result.
11
12 The impact of the transaction on TEP's financial standing and credit ratings is a critical
13 measure of whether the acquisition is a good one for TEP's customers and debt investors.
14 In his pre-filed testimony, Mr. Pignatelli said that the proposed transaction would
15 significantly improve the financial health of TEP. The transaction would allow TEP to
16 pay down up to $260 million of its debt, reduce interest expenses, and increase its
17 percentage of equity capital. Taken alone, these are clear benefits. However, judging the
18 transaction's overall effects on TEP requires a broader perspective.
19
20 Positive aspects of the proposed transaction include the improvement in TEP's stand-alone
21 capital structure and operating cash flow, especially as a percentage of debt outstanding.
22 TEP's equity ratio using the Commission method is expected to increase to approximately
23 40 percent of total capitalization. Cash flow will increase significantly as a result of

1 lower interest and line of credit fees. The improvement in these factors does support an
2 increase in TEP's credit quality, if it were to be judged on a stand-alone basis.
3
4 Improving TEP's stand-alone capital structure and cash flow statistics by issuing
5 additional debt at the parent company, however, will increase the debt leverage of the
6 consolidated enterprise of which it forms a part. The purchase of UniSource is to be
7 financed by the issuance of $660 million in new debt at the parent and with $557 million
8 in equity and cash. After paying UniSource shareholders and costs of the transaction,
9 about $260 million of cash would be injected into TEP. TEP would use the cash to pay
10 down its long-term debt. Overall, the consolidated debt of the UniSource entity will
11 increase by approximately $400 million on a net basis.
12
13 The free cash flow of the utility will be needed by the holding company to service the
14 interest and principal payments on the expected $660 million of LBO debt and to provide
15 a return to the investors. The increased levels of debt at the holding company increase the
16 pressure on TEP's financial profile, because TEP is the primary source of funds for
17 UniSource.
18
19 **Q. How do the credit rating agencies view the proposed LBO transaction?**
20 A. The major credit rating agencies view the transaction as either negative or neutral for the
21 credit profile of TEP. Standard and Poors' has placed TEP on its CreditWatch with
22 negative implications, specifically due to their analysis of the transaction. Standard and
23 Poors' analyst notes that:
24
25 Standard and Poors' prior stable outlook on TEP was based on the
26 expectation that UniSource would continue to work toward reducing its
27 overall debt burden. Now, however, TEP's rating may be lowered in the

> near-term, after a thorough review of the details of the transaction, because of UniSource's unexpected move toward a leveraged buyout structure, which, regardless of whether the transaction is completed or not, raises questions about management's commitment to credit quality.

The Standard and Poors' opinion recognizes that the additional consolidated leverage that the merger would produce would place TEP under more financial pressure, and that the transaction could reverse, or delay, the TEP debt-reduction process that has had a stabilizing influence on credit standing for some years.

Moody's and Fitch view the transaction as neutral for the stand-alone credit profile of TEP. Both note the positive implications of the debt reduction at TEP, but also cite increased debt levels on a consolidated basis, and the resulting, additional pressure to provide TEP dividends to service the debt. Moody's notes that the dividends required from TEP to service the $660 million of LBO debt will be "less discretionary in nature" than normal utility dividends to the parent holding company. Moody's and Fitch are expecting to keep TEP credit ratings at current levels; however, there is nothing in their statements to support a view that they foresee improvement in TEP's credit profile.

Q. How does the proposed acquisition structure affect TEP's equity capital and its cash flow?

A. UniSource has proposed to pay down about $260 million of various, outstanding TEP long-term debt instruments with a portion of the proceeds from the transaction. The immediate impact would increase equity capital, both absolutely and as a proportion of

1 total capital. Applicants also estimate that the paydown would reduce annual TEP interest
2 and letter of credit expenses by about $18.7 million annually. (See direct testimony of
3 Joel M. Reiker. Exhibit JMR-9.)
4
5 **Q. What does Staff observe from presentations made to rating agencies?**
6 A. UniSource made presentations regarding the effects of the LBO transaction to the credit
7 rating agencies in January 2004. The presentation showed, among other things, the effects
8 of the recapitalization of TEP and the projected improvement in TEP's financial ratios.
9
10 The credit rating agencies use four to six financial ratios as key quantitative indicators in
11 evaluating utility company credit. Standard and Poors' is the only major rating agency that
12 publishes an explanation of how it uses financial ratios specifically in performing credit
13 ratings. The UniSource presentations to rating agencies projected stand-alone financial
14 ratios for TEP in 2004-2008 that showed [redacted].[1]
15
16 TEP's funds flow from operations as a percentage of average debt was projected to [redacted]
17 [redacted]. For the same period, TEP's funds flow
18 interest coverage was projected to [redacted]. Total debt to
19 EBITDA was projected to [redacted].
20 EBITDA interest coverage was projected to [redacted].
21

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

1 To summarize, the TEP stand-alone financial statistics presented to the credit-rating
2 agencies show improvement to levels supporting higher ratings.
3
4 **Q. Does Staff anticipate a credit-rating improvement to the level suggested by stand-**
5 **alone TEP conditions?**
6 A. No. The improvement in TEP's financial indicators will be overridden by the
7 consolidated holding company's increased debt burden, absent specific utility protections,
8 which the applicants have not proposed. Without such protections, TEP's financial
9 standing and credit profile will not be viewed on a stand-alone basis. Financial
10 considerations involving the rest of the proposed family, including the LBO structure, will
11 comprise a material element in rating-agency assessments.
12
13 **Q. What is the basis for this opinion?**
14 A. All of the rating agencies, especially Standard and Poors', have changed their approach to
15 rating utility holding companies during the past several years. They no longer evaluate
16 utility companies within a holding company family solely on the basis of the utility
17 sector's stand-alone credit profile. They consider the effects of co-existence with the
18 consolidated holding family. This evolving approach recognizes that the financial
19 standing and credit issues of other members of the holding company family can and do
20 affect the utility family members. A number of cases prove that financial problems of
21 non-regulated affiliates cause credit downgrades at healthy utilities.
22
23 **Q. Can you provide some examples?**

1 A. We are directly familiar with two. First is NUI, where utility ratings fell significantly
2 below investment grade as a result of financial weakness at the holding company level,
3 despite sound utility performance. NorthWestern Energy provides a second example and
4 it shows how extreme the resulting consequences can be. There, the insolvency of non-
5 utility businesses caused the bankruptcy of the entire holding company, including two
6 utility entities. More locally, Arizona Public Service's credit rating was reduced severely
7 in the late 1980's due to the insolvency of holding company affiliate MeraBank.
8
9 **Q. Why does Staff believe that there is a failure to protect TEP effectively from what**
10 **may happen at its affiliates?**
11 A. Experience with the holding company structure in the U.S. over the past 10 to 15 years has
12 shown that providing separate corporate structures for businesses below a common
13 holding company does not alone effectively shield affiliates from each other. Financial
14 problems at one holding company subsidiary can spread to other members of the family
15 through interlocking financing structures, cross-collateralization of assets, guarantees and
16 credit support, and other cross-supporting measures.
17
18 Even in the absence of direct financial ties among holding company affiliates, financial
19 troubles at one holding company subsidiary are often not isolated. The holding company
20 parent generally has both the incentive and opportunity to tap a healthy subsidiary for its
21 cash or collateral resources to provide financial support. In cases where more extreme
22 financial distress results in holding company insolvency, healthy family members, which

1 typically means the utility subsidiaries, find themselves included in bankruptcy with their
2 affiliates. Such "piercing of the corporate veil" has become established, making the
3 holding company structure ineffective as a sole measure for protecting individual
4 company interests.
5
6 The credit rating agencies have recognized the lack of true separation by beginning
7 increasingly to analyze the entire consolidated family and potential credit impacts on one
8 member from circumstances affecting the others.
9
10 **Q. Are there any means to secure for TEP the stronger financial position and higher**
11 **credit rating warranted by its new, stand-alone capital structure and strong cash**
12 **flow?**
13 A. Yes. TEP and the UES utility entities need specific protections, commonly called ring-
14 fencing, to shield them from creditors of affiliates and potential financial problems within
15 the holding company family. Adequate ring-fencing protections secured through a series
16 of conditions imposed by this Commission would increase the emphasis that rating
17 agencies place on TEP's own financial conditions in assigning credit ratings. Proper ring-
18 fencing would allow TEP's credit rating to improve as its capitalization and cash flow do.
19
20 **Q. What particular elements are necessary for providing the ring-fencing described?**
21 A. Ring-fencing for a regulated utility in a holding company structure generally includes
22 protections for the equity capital, assets, operations, and transactions of the utility. Ring-

fencing builds a protective firewall around the utility to protect it from other creditors or competing financial interests within the holding company structure. The intent of the ring-fencing measures is to:

- Preclude the removal of equity capital
- Bar the pledging of utility assets or financial resources
- Prevent indirect use of utility resources for non-utility purposes
- Preserve the capital investment and maintenance levels of utility operations.

Q. What particular ring-fencing elements does Staff consider appropriate to protect TEP in this situation?

A. A key ring-fencing protection for TEP would require the maintenance of minimum utility equity levels. TEP needs to build its equity capital position, as this Commission has observed, and as it has sought to induce over the past 15 years. The short-term improvement to TEP's equity capital is a positive feature of the proposal before the Commission in these proceedings. However, TEP's equity position needs not only to be built, but also maintained at adequate levels.

We would recommend an equity capital standard that would not allow TEP's equity position to slip back after it has been built up. An equity maintenance provision would set a minimum equity level for TEP as a percentage of its total capitalization. This percentage equity level should also consider that TEP's $760 million of capital leases are

1 considered as debt in a credit evaluation, as are portions of the fixed payment amounts of
2 major purchased power and fuel contracts.
3
4 The establishment of minimum equity levels for TEP provides effective protection for the
5 utility's capital. Affiliates would be barred from dipping into TEP's equity to solve
6 financial problems in the other parts of the holding company. On the other hand, if
7 adequate equity levels should be maintained at TEP, all of its earnings would be available
8 to dividend to UniSource and the Partnership.
9
10 **Q. Doesn't this Commission already impose a limitation on TEP dividends?**
11 A. The current limitation on TEP dividends is 75 percent of TEP's net income annually, until
12 TEP reaches 40 percent equity, as measured by this Commission's ratemaking capital
13 structure method. The intent of this restriction was to build TEP's low levels of equity
14 capital over time.
15
16 The transaction before the Commission now is expected to remove the application of the
17 TEP dividend limitation, by increasing TEP's equity percentage to 40.25 percent, again
18 using the Commission's method of calculation. Should there remain no limitation
19 imposed by this Commission, the removal of the dividend limitation would leave the
20 Federal Power Act dividend restriction on utilities as the only limit on TEP dividends.
21 Section 305(a) of the Federal Power Act allows the distribution of all retained earnings of
22 a utility, but not the capital stock. TEP's retained earnings are currently negative;

therefore, the dividend restriction would be 100 percent of net income until TEP had a positive balance of retained earnings. (See Exhibit JA-1) TEP would be allowed to dividend all positive retained earnings existing on its books after reaching a positive retained earnings balance.

Staff believes that TEP's equity capital and related credit coverage ratios should be built until TEP achieves and maintains a profile generally consistent with an investment-grade credit rating. We would recommend a minimum equity ratio for TEP that is consistent with such a rating. Dividends need only be restricted to the extent necessary to assure satisfaction of that minimum standard. We recommend an affirmative obligation by the parent to maintain the minimum required equity level in order to protect TEP's financial status, simplify understanding of the equity and dividend issues, and eliminate any confusion about dividend restrictions. As long as TEP were to maintain minimum equity capital levels consistent with an investment-grade rating, TEP could dividend all earnings and equity capital above this level to the parent.

Q. What other ring-fencing measures would Staff recommend?

A. A more complete list of recommended ring-fencing provisions for TEP follows:

- Utility capital ratios (as measured by rating agencies in consideration of items such as capital leases, for example) should at all times be maintained at levels consistent with efficient and economic acquisition of debt by utility enterprises
- TEP should attain targeted credit ratings improvements by times certain

- Financings and financing arrangements for the utility operations should remain separately negotiated and structured
- There should be full segregation of utility funds in separate cash management systems
- Utility assets, financial support, or cash flow should not be pledged for other than utility benefit
- There should be protection from bankruptcy and insolvency of affiliates
- Inter-company loans should not be allowed
- There should be protection of Commission oversight, authority and financial reporting

Q. Where have such ring-fencing protections been used before?

A. Perhaps the best-known adoption of ring-fencing protections in the utility business came from the Oregon commission in the 1997 acquisition of Portland General Electric by Enron. A key feature of the PGE ring-fencing was the minimum equity-level provision. The strength of the PGE ring-fencing was proven by Enron's bankruptcy. While other pieces of the Enron business were dismantled or used as collateral to address Enron's collapsing finances, the PGE operations and finances were effectively protected from Enron and its creditors.

1 The acquisition of Texas-New Mexico Power in a leveraged buyout in 2000 also included
2 a number of conditions for Texas commission approval. The conditions in this leveraged
3 buyout were similar to those that we have proposed.
4
5 **Q. Do the proposed acquisition and its structure provide financial benefits when**
6 **compared to circumstances and projections regarding UniSource and its utilities in**
7 **the absence of the acquisition?**
8 A. The answer depends on which stakeholders are being considered. Existing and future
9 investors gain significant benefits. Customers do not, as this transaction is now structured.
10
11 There are significant benefits for existing shareholders; they get a premium of about 30
12 percent. It also appears that the new investors have strong prospects for securing high
13 returns on invested capital. The added debt associated with the transaction forms a
14 material part of the circumstances promoting those prospects. On an overall basis, the
15 transaction makes economic sense from this perspective. However, all benefits go to these
16 two groups. The benefits will come from the cash flow generated by the utilities,
17 principally TEP. However, these entities, especially TEP, receive no net financial
18 benefits, but become exposed to additional financial risk.
19
20 **Q. Summarize what Staff expects to result from the utility "ring-fencing" protections**
21 **proposed.**
22 A. If the Commission were to order the "ring-fencing" protections for the utilities that we
23 have proposed, the credit rating agencies would place more emphasis on the utilities' own,
24 internal credit characteristics. TEP would become a significantly more attractive credit

risk, and would probably be upgraded steadily over time. Rating agencies are slow to upgrade companies with improving credit quality; they like to make sure that financial improvements are more permanent and not fleeting in nature.

Affiliate Issues

Q. Does Staff believe that the applicants have adequately addressed affiliate issues?

A. Staff believes that the applicants have not been sufficiently clear about their position on affiliate issues, such as allowable transactions between affiliates, pricing for those transactions, policies and procedures for shared services, use of confidential customer information, preferential access to services or assets, required reporting for non-tariffed transactions and employee transfers, and access to books and records. Also, it is not clear how broadly or narrowly the applicants define the term "affiliate."

Q. What is Staff's position on the propriety of a continuation of waivers of affiliate interest rules granted in Commission Decision No. 62103?

A. The applicants have stated in response to JMR 3-67 that they believe the waivers (see Exhibit JA-2) to the Affiliated Interest Rules that the Commission granted to UniSource Energy in Decision No. 62103 would continue to apply after the proposed merger. They also state that they will present to the Commission for approval any waivers to the Affiliated Interest Rules needed by Saguaro Utility Group.

1 Staff believes that there has been no showing that continuation of waivers granted in
2 another context is appropriate to circumstances following any approval of the relief
3 requested in these proceedings. Such a showing should be required for each waiver
4 sought, including a continuation of any waivers granted previously. Staff also believes
5 that the waived requirements generally address important aspects of assuring that there is
6 no harm to customers.
7
8 **Q. Do any waivers concern Staff particularly?**
9 A. All of them do, although Staff certainly would be interested in addressing how each
10 waiver that the applicants wish to continue or create would serve the public interest. Staff
11 believes that the Commission should recognize that the new structure and the new
12 interests in TEP being created here might cause significant changes in the courses of
13 dealing between the utility and its affiliates. The Commission should also recognize that
14 access to information about the holding company would be of a different character after
15 public disclosure requirements change. Staff believes that these changes call for a specific
16 examination of any waivers, either new or continued.
17
18 **Q. Do the Affiliated Interest Rules address all of Staff's concerns?**
19 A. No. The Affiliated Interest Rules cover the Commission's review of transactions between
20 public utilities and affiliates. In general, A.A.C R14-2-804 states that, in order to transact
21 business with an affiliate, the utility must agree to provide the Commission with access to
22 the books and records of the affiliate to investigate transactions between the two. The

1 utility is also obligated to maintain necessary accounting records regarding transactions
2 with each affiliate.
3
4 These rules do not specifically address such issues as the pricing of affiliate transactions,
5 the use of confidential customer information, or policies and procedures for shared
6 services. These issues are usually addressed in a Code of Conduct and Cost Allocation
7 Manual. Utilities typically specify methods for allocating costs that govern the pricing of
8 services among affiliates in a cost allocation manual.
9
10 **Q. Is a proper Code of Conduct in place?**
11 A. Staff and the Commission previously examined the issue of required modifications to
12 existing Codes of Conduct in a restructured electric industry. In its October 28, 2003
13 Order, the Commission concurred with Staff that TEP did not have any affiliates that sell
14 wholesale or competitive retail electricity, and therefore did not require a Code of Conduct
15 addressing interactions between TEP and those affiliates. The Commission noted that if in
16 the future TEP either forms or acquires an affiliate that sells wholesale or competitive
17 retail electricity, it should file a revised Code of Conduct for Commission approval. In
18 this proposed reorganization, entities having other investments in the utility industry will
19 acquire TEP. While this situation was not directly addressed by the Commission's Order,
20 Staff believes that the proposed reorganization makes it appropriate to establish and
21 operate under a proper Code of Conduct.
22
23 **Q. Why is it particularly important to address these affiliate issues for this transaction?**
24 A. The investors in this transaction are private entities, some of which are already involved in
25 the utility industry. For example, KKR has a significant investment in DPL, a diversified

energy company that owns Dayton Power and Light and DPL Energy, and was one of two partners to purchase International Transmission Company ("ITC"), which held the transmission assets of Detroit Edison. It is important to keep in mind that these partners can be expected to continue making investments in other companies, some of which are likely to be energy-related, in the future. There is no way for the Commission to anticipate the degree to which these affiliate issues will become increasingly relevant. The Commission's opportunity to address issues regarding the utility companies and future energy-related affiliates is now. Also, it is important to keep in mind that three of Saguaro Utility's investors, KKR, J.P. Morgan Partners, and Wachovia, are actually consortia of private equity, and represent capital from many unidentified sources. The potential for future conflict among such a broad network of companies is real, and would certainly be difficult for the Commission to trace without some sort of explicit reporting requirements. Consider, for example, a hypothetical situation in which one of the J.P. Morgan companies provided financial services to TEP. It is reasonable for the Commission to be interested in the extent to which TEP procured those services at arm's length, and whether the price TEP paid for those services was reasonable.

Staff believes that it is therefore important that the applicants agree to a sufficiently inclusive definition of the term "affiliate" as used in both the Affiliated Interest Rules and any future Code of Conduct or Cost Allocation Manual. Specifically, the definition should not be narrowly construed to mean only Saguaro Utility Group and its affiliates. It needs sufficient breath to include those entities in which the general and limited partners of Saguaro Utility Group or their associated investment companies have a substantial interest.

1 **Q. Have other commissions taken steps to address affiliate issues in the context of a**
2 **merger with a non-utility?**
3 A. Yes. The stipulation agreement executed in connection with Enron's acquisition of PGE
4 contained a considerable number of conditions related to affiliate issues, including cross-
5 subsidization, potential market abuses, and access to records. Enron agreed to, among
6 other things: (1) allow the commission to audit the accounts of Enron and its unregulated
7 subsidiaries to determine the reasonableness of allocation factors used to assign costs to
8 PGE; (2) provide the commission access to all books and records pertaining to
9 transactions between PGE and all affiliated interests; (3) provide regular reports to the
10 commission regarding affiliated interest transactions, employee transfers, and consulting
11 activities; (4) not give affiliates preferential access to power or gas capacity or assets, and
12 (5) not provide customer information to affiliates and non-affiliates without written
13 permission.
14
15 **Q. What does Staff propose?**
16 A. First, the parties should make explicit their agreement on their interpretation of the term
17 "affiliate." Second, the parties should make explicit the applicability of waivers to the
18 Affiliated Interest Rules. UniSource should develop an appropriate Code of Conduct
19 governing the interactions of TEP, as well as UNS Gas and UNS Electric, with affiliates.
20 To the extent that it does not already have one, UniSource should be required to develop a
21 Cost Allocation Manual for Commission approval.
22

Reliability Issues

Q. Mr. Reiker's testimony addresses the kinds of pressure to cut costs that arise in the context of leveraged buyouts. Does Staff see risks in that regard as a result of the Commission granting the relief requested in this proceeding?

A. Yes, most utilities feel such pressures, and in the case of this proposed transaction concerns are heightened by the financial structure that the new owners will be using to make the acquisition.

Q. Please explain.

A. Our work has uncovered a number of cases of reduced attention to public-service infrastructure in the recent past. We have been experiencing across the country strong pressures for controlling costs. These pressures spring partly from a general awareness of the need to promote efficiency in all sectors of the American economy. In the utility industry, the rate "freezes," "moratoria," and other similar arrangements that have resulted from restructuring have precluded rate cases as a means of recovering cost increases, thereby heightening interest in finding ways to cut costs. Third, long-term declines in rates of inflation, financing costs, and the like have provided extra opportunity for cost-conscious companies to increase profitability while staying out of rate cases. Finally, a wave of consolidation in the industry has, I believe, led some to increase their attractiveness to potential suitors by increasing profitability short term by reducing expenditures on infrastructure.

A thinned capital structure caused by taking on new, extra debt, with the associated interest and amortization, compounded by a need to provide healthy returns to

sophisticated institutional investors, can only increase the pressures. A desire to make added future investments in other businesses would tend to have the same effect.

Even experienced utility leadership can be deceived into thinking that cutting capital and operating expenditures is a low-risk way to improve cash flow and profitability. The reason is that the consequences of those cuts can be delayed. Such a delay can produce an illusion that what has been cut is not really necessary to preserving the reliability, safety, and efficiency of service. Short-term cuts then become long-term, institutionalized ones and adverse effects eventually follow.

Q. What commitments have the Investors made about maintaining the quality of the service that the utilities will provide when they own UniSource?

A. The Investors made some general statements about this topic. In the response to Chairman Spitzer's first set of data requests, at 1.3, there is this reference to the Merger Agreement:

> To support the value of their investment and to meet their "obligation to serve", the Investors have agreed to the following undertakings in the Merger Agreement:
> a. Existing TEP, UNS Gas and UNS Electric assets shall be managed, including appropriate expansion of such asset base, to accommodate service territory growth; and
> b. UniSource Energy and its subsidiaries shall continue to invest adequate capital to provide safe, reliable and adequate service to TEP's, UNS Gas's and UNS Electric's customers.

Mr. Pignatelli's testimony echoes these points about the merger agreement.

Q. Does Staff believe that these are sufficient commitments about maintaining the utilities' quality of service after the merger?

1 A. No. Staff accepts these statements as proper expressions of overall guiding principles, but
2 they do not reflect commitments whose satisfaction can be determined by objective
3 measures. Moreover, they do little more than restate self-evident public service
4 obligations. They therefore express only the general expectations that customers and
5 regulators usually have of utilities. Meaningful and enforceable commitments, by
6 contrast, have sufficient specificity to allow an independent observer to reach a conclusion
7 about success in meeting a standard without application of the wide degree of judgment it
8 would take to determine satisfaction of the "commitments" as proposed by the applicants
9 here.
10
11 **Q. Should the Commission be satisfied with these principles, as the utilities have no**
12 **service-quality commitments in place now, and current management will remain in**
13 **place?**
14 A. Staff's opinion is that there should be more in the way of commitments. As the new
15 owners have no track record in the utility industry as controlling owners, generally, and in
16 Arizona more specifically, it is prudent to have a healthy measure of skepticism about
17 their commitment to directing the management of the utilities in a way that meets the
18 reasonable expectations of customers. Staff believes that it would be reasonable for the
19 Commission to have concerns about what this merger could mean about the quality of the
20 service to be provided by the utilities.
21
22 Staff has already testified to the pressures to generate maximum cash flows in order to
23 reduce the extraordinary leverage created by buyouts of the type at issue here. Moreover,
24 the existence of rate freezes can only heighten the pressure to find cost-reduction

1 opportunities. The retention of current management would provide some reassurance that
2 utility experience will not be ignored as such reductions are sought. However, the drastic
3 changes in governance structure above that level gives significant cause for skepticism.
4 Above the utility executive level in the proposed governance structure there is no
5 substantial experience in overseeing entities with public service responsibilities like those
6 that the UniSource utilities have. There is also not even a guarantee that significant utility
7 operating experience will remain; certainly routine personnel changes can be expected, at
8 the least.
9
10 **Q. How would Staff suggest that the Commission reduce the risks of reductions in**
11 **service quality?**
12 A. Staff will describe a number of options. The first is to establish, as some commissions
13 have done in similar circumstances, quantitative measures of service quality against which
14 the utilities' performance would be judged. The second is to bind the utilities to not
15 reducing their capital and operations and maintenance expenditures to levels below what
16 they have recently been. The third is to expose utility management and operations to
17 outside review conducted on behalf of the Commission.
18
19 **Q. Discuss these approaches.**
20 A. Many utilities now have service-quality measures by which they and their regulators and
21 customers judge their performance. These quantitative measures are typically those that
22 customers can directly perceive, like how quickly telephone calls are answered, the length
23 and frequency of interruptions of (electric and telephone) service, and a utility's speed in

installing new service. Some utilities pay customers when their performance falls below a standard.

Commitments to specified levels of expenditure are less common. Their advantage over the first approach is that they deal with the most likely cause of inadequate performance, while the first approach deals only with effects. The focus on inputs as opposed to outputs can allow the root causes of problems to be observed and addressed before customers discern their effects. One of the options that could be used in a case like this is to require the utilities to maintain their capital and O&M expenditures at some rate, *e.g.*, at about the inflation-adjusted levels that they were in a defined historical period, or at levels that a utility has already projected.

The third approach is actually a variation on the second. It recognizes that pre-set minimum expenditure requirements may not be flexible enough to address emerging circumstances and needs. Even the best forecasters in the utility business are far from perfect. One must always expect plans to require adjustment even if there are no major unforeseen events. When circumstances diverge from expectations, such adjustments may be extreme. In those events, judging performance against pre-set limits can give impetus to conduct that ultimately disserves customer interests. If the relevant service territories here are in fact likely to experience significant growth for some time, then simply maintaining the current level of expenditures actually may effectively mean reducing them.

1

2 **Q. What option does Staff recommend the Commission choose as a condition of its**
3 **approval of this merger?**

4 A. Staff recommends an outside examination. Staff also recommends development of
5 specific standards, but in proceedings separate from this consideration of merger approval.

6

7 **Q. Why do you recommend later consideration of the adoption of standards?**

8 A. Staff does not believe that these proceedings can give full consideration to all of the issues
9 involved in setting such standards. It is critical that the standards be set properly. If the
10 standards reflect the current service quality that the utility provides, the question arises of
11 whether the current quality is sufficient, and choosing the right measures and associated
12 objectives takes work and time. Given the schedule inherent in merger proceedings, they
13 are not good ones for reaching the level of detail required. However, Staff recommends
14 that the Commission consider the adoption of such standards and, should it agree, that it
15 require acknowledgement of that consideration by the applicants and recognition of the
16 ability to impose them.

17

18 There are other reasons that standards are not alone sufficient. Should they be set too low
19 and therefore easy for the utilities to meet, then little may be accomplished. In addition, it
20 can be challenging to set standards that are meaningful to all types of customers. Next,
21 even if there were standards that all parties agreed were desirable and reasonably
22 achievable, there is the problem of what happens if a utility's performance falls below

1 them. There can be arguments that a standard was not met because of extraordinary
2 circumstances, such as severe disturbances caused by weather, and so assessing penalties
3 becomes a potential matter for adjudication.
4
5 There is also the question of whether the utility's reporting of its performance is accurate.
6 There is no reason to believe that the UniSource utilities are dishonest or incapable, but
7 we have encountered significant examples of misreporting of performance, from
8 misperceptions of the applicable requirements, from gaps or flaws in data collection
9 methods and activities, and, in fortunately very rare circumstances, from manipulation of
10 information.
11
12 Finally, there is the problem that measures of service quality are lagging indicators. That
13 is, the degree to which a utility is able to meet or exceed some standards or otherwise keep
14 its service quality at levels to which customers are accustomed or are otherwise acceptable
15 is a function of past expenditures. The issue here is assuring that a new ownership group,
16 which is strongly motivated to increasing the cash produced by its utilities, continues to
17 make the capital and O&M expenditures that are needed to provide safe, efficient, and
18 reliable service. Should the transaction close and should the new owners in fact decide to
19 reduce expenditures, the effects may not be observable for some time. Further, in that
20 scenario, if reductions are made and service suffers, it will take some time to recover from
21 the lack of spending. This would create a situation requiring utility customers and the
22 Commission to invest extra time, effort, and expenditures to overcome. It may also

1 require customers to suffer lingering service-quality problems for an extended "recovery"
2 period.
3
4 **Q. Why does Staff not recommend the second option, dealing with expenditure levels?**
5 A. This option would require the utilities to commit to quantified levels of capital and O&M
6 expenditures that give some assurance that there will not be degradation in the reliability,
7 safety, and efficiency of service and operations. This approach would require some
8 analysis of what the utilities have been spending and projections of what they will need to
9 spend in the future. The latter aspect is the one that introduces the complexity to setting
10 the parameters of such approach. For instance, if a utility has just finished a major capital
11 project or several projects, then future capital expenditures could be lower, and the
12 recently-invested capital might produce O&M savings. In that scenario, a utility might
13 legitimately have lower expenditures, but still violate a commitment. A related aspect of
14 such a scenario is that a utility's staffing levels would increase and then decrease and
15 using staffing as an indicator of commitment to maintaining quality and efficiency would
16 again raise questions.
17
18 **Q. Please describe more specifically the dimensions of Staff's audit recommendation.**
19 A. Staff recommends that the Commission condition the approval of the requested relief on
20 an agreement to a utility-funded, commission-sponsored management and operations audit
21 to commence not more than 18 months after the ownership transition, to be conducted by
22 Staff and a firm selected by the Commission, with utility funding in an amount not less

than $400,000. As a parallel condition, UniSource should be required to maintain accounting and business management records in the same form as kept now, unless approved by the Commission. This condition will provide assurances that the coming audit can properly establish spending and performance trends. It will also allow the Company flexibility to make important changes, should it be able to make a case instituting them before the audit.

The Commission Staff would prepare a scope of work, and identify the firms capable of performing the work with the required levels of expertise, experience, and independence. Many commissions across the country have already established useful scope documents and lists of firms that meet such criteria. The Commission Staff would then issue a request for proposals ("RFP") to a list of firms that Staff approves. That RFP would solicit proposals to perform the scope of work identified for a not-to-exceed cost. The Staff would evaluate responses, and determine which proposal best responds to the RFP. What follows in most states thereafter is a three-party contract involving the selected consultant, the Company, and the Commission, or a two-party, Commission-drafted and approved contract between the selected consultant and the Company. Either contract type generally provides that a Commission Staff designee is responsible for managing and controlling the work of the consultant, and provides that the Company is responsible for cooperation in making people, work sites, and documents available and for paying for the audit in accordance with the agreed-upon terms.

Such audits generally work to a fixed deadline, and require defined deliverables. The work scope is usually addressed in terms of specific areas of focus, which here should include governance, affiliate transactions and costs, and a number of areas as they relate to utility cost of service, including, without limitation, areas such as:

- Strategic and operational planning
- Budgeting
- Capital expenditures
- O&M expenditures
- Measures of work planned and performed
- Maintenance planning, performance, and backlogs
- Performance measurement
- Comparative and trended expenditures and work performance

Governance, Regulatory Oversight, and Community Presence

Q. The new holding company will have a board of directors made up of two people, Messrs. Pignatelli (an inside director) and Rentschler, in contrast to the UniSource board, which has 10 outside directors. Does that change in board composition concern Staff?

A. Yes. Staff asked UniSource for the proposed composition of the board of directors of TEP (the other utilities would also have a board). The Company replied that it has not yet been determined. (See Exhibit JA-3) Absent a commitment to retain a utility-level board with substantial outside membership, these concerns remain substantial. Given the recent

1 attention being paid to corporate governance—albeit focused on publicly-held
2 corporations—and the fact that utility boards generally have broad representation from
3 different constituencies and sources of expertise, Staff believes that the new owners
4 should commit to retention of a board with substantial outside membership at the utility
5 level.
6
7 **Q. Does Staff believe the Commission should condition its approval on the new**
8 **UniSource having a board similar to the one in place now?**
9 A. Yes. Such a board could provide both owners and managers with a source of advice that
10 Staff considers valuable. The Commission should require that the applicants maintain a
11 utility-level board.
12
13 **Q. What concerns does Staff have with respect to assurances about maintaining**
14 **headquarters in Tucson?**
15 A. It is logical that the new owners expect to keep UniSource's headquarters in Tucson,
16 because this is not a merger with another utility. That said, there has still not been a firm
17 commitment to keeping operations centered in this area for a firm period of time. For that
18 reason, the Commission should require a commitment to keep headquarters and principal
19 operating locations in Tucson indefinitely, and should further require the approval of this
20 Commission before moving them.
21

Q. Does Staff think that the Commission should have concerns about KKR being the new majority owner of the holding company?

A. This issue falls into the general category of the potential risks to which a new owner exposes customers, employees, and the communities that the UniSource utilities serve. The special question that KKR's ownership position raises is exemplified by its large ownership position in DPL Inc., the holding company whose main business is Dayton Power & Light, an Ohio electric utility. DPL has recently encountered substantial problems with rating agencies, has had its controller write a potentially troubling memorandum to an outside director, has delayed the filing of its Form 10-K with SEC, and is now subject to an investigation by the Public Utilities Commission of Ohio. After KKR took its ownership position in DPL the holding company made a large investment in non-regulated, non-utility companies.

Staff believes that the Commission should require that non-utility investments made outside the normal course of utility operations receive prior Commission approval. Controls can take the form of limiting the amount of capital invested in non-utility operations. Moreover and as noted earlier, assuring that the new owners agree on a sufficiently broad definition of affiliates is important to assuring that transactions of potentially less than arms'-length come to this Commission's attention on a timely basis.

Q. Does Staff have any concerns about JPMP as an owner?

A. Yes. JPMP has a general interest in energy investments in or related to the utility industry. There arises the question of whether JPMP or an affiliate would have an interest in buying and selling wholesale electricity or natural gas with the UniSource utilities, and whether it would be in a position to take advantage of its ownership position, at the possible disadvantage of those utilities' customers. Again, the accepted definition of affiliates and affiliate transactions must be sufficiently broad to assure that there is arm's-length dealing.

Q. Can an LLC structure permit circumvention of the normal process for approving a change of ownership by substituting another group and effectively changing ownership?

A. Discussed below are the factors that significantly distinguish the role of the partners (general and limited) from those of traditional utility or utility holding company investors. Staff believes that the Commission should take steps to prevent the creation of a structure that can be used as a shell or vehicle that permits the free transfer of ownership and control without Commission approvals subsequent to the one being sought here. The partners should be deemed for Arizona regulatory purposes as controlling UniSource and its utility subsidiaries, given their powers and the structure they have created. Whether these powers and structure comport with federal requirements about holding companies is not particularly meaningful in this regard.

1 Staff believes that this Commission should condition any approval of this merger on the
2 condition that there can be no change in the general partner and no material change in the
3 limited partnership interests without Commission approval.
4
5 **Q. If this merger closes, will the Commission and other interested parties have the same**
6 **access to information that is useful to regulation about the holding company and the**
7 **utilities after the merger?**
8 A. Entities within the new company will have to continue to file prescribed reports with this
9 Commission and the Federal Energy Regulatory Commission. In addition, as long as the
10 holding-company subsidiaries continue to have publicly-held debt, at least the utilities will
11 have to file Forms 10-K with the SEC. Those forms require the reporting of information
12 that has value to other regulators, such as the Commission. The filing that will no longer
13 be required is a proxy statement, which discloses director and officer compensation. The
14 Form 10-K has provision for that disclosure, which usually then references the proxy.
15
16 Beyond that, there is the question of what general attitude and approach new ownership
17 and management will take with respect to disclosure. They are clearly used to operations
18 that do not involve the kinds of dialogue that I believe are expected in the utility industry.
19 They operate in very entrepreneurial and competitive marketplaces where there is a great
20 sensitivity to the commercial value of information. Staff should note, however, that this
21 sensitivity is growing in the utility business as well, as it becomes more competitive in
22 some respects.

It is reasonable for the Commission to conclude that, absent special measures, new ownership and management will be at least somewhat more reluctant to share information, particularly information that arises from the top and new levels of the structure that this merger would produce. Experience from data requests in this proceeding has given some indication about the question of information sharing. Before securing the critical, entry-level merger approval needed from this Commission, the applicants, one might argue, should be exhibiting the maximum expected level of willingness to share information. Therefore, problems at this point in time could be expected, if anything, to be magnified after that approval is gained.

The responses to data requests seeking information from the new investors have demonstrated that there is much sensitivity to sharing information from that level. It is difficult to draw firm conclusions yet. The information sought is clearly sensitive. There has not been much time for dialogue about the need for having it or the protections necessary before providing it. Much of what has been asked for has been given, but material portions have not. They have been redacted from documents provided. Staff expects to continue the dialogue about this information as subsequent filing dates in this proceeding approach. Staff expects that its surrebuttal testimony specifically will come at a time when more definitive observations can be made.

Q. Describe the business of the Partnership.

A. The *Agreement of Limited Partnership of Saguaro Utility Group L.P.*, dated as of November 21, 2003, describes the business of the Limited Partnership. The Partnership's name is Saguaro Utility Group L.P. The business of the Partnership is not [redacted].

Q. What is the Partnership's principal place of business?

A. The agreement recites a [redacted].

Q. How is the Partnership structured?

A. The general partner is [redacted].

[redacted].

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Q. Can the general partner freely transfer its interest in the partnership to another entity under the limited partnership agreement?

A.

Q. Does the limited partnership agreement impose other restrictions on ownership of the general partner?

A.

Q. Is there an analog for limitations and restrictions of this type in publicly held utility corporations?

A. No. Utility ownership can be described as a "community of strangers." Here, the partners have attached significant importance to avoiding such ownership, which indicates an expectation about the management and operational role for the general partner.

Q. What costs of the Partnership should UniSource and its utility subsidiaries pay?

A. The merger will displace no utility functions or personnel. No costs of the Partnership would be necessary absent the change in ownership. Customers should pay none of the partnerships costs of the merger transaction or of the partnership's post-merger operation. The Commission should condition approval of the merger on acceptance of such non-recovery and upon an agreement to provide such access to the books and records of any affiliate, as necessary to verify compliance with this condition. This compliance should permit the Commission to conduct such examinations whether or not in the context of rate proceedings.

Q. How, if at all, can the Partnership be said to "control" UniSource and its utility subsidiaries for Arizona regulatory purposes?

A. The right of the Limited Partners [redacted] is beyond what utility and utility holding company shareowners typically exercise. These rights can hamper management's ability to make effective and prompt decisions. Insistence upon retaining them would raise concerns about the intentions of the new owners to refrain from making inappropriate reductions in utility operations-and-maintenance and capital-expenditure decisions.

1 **Q. What is the relevance of revenue, expense, and cash flow projections to this**
2 **proceeding?**
3 A. They provide an important indicator of the rate levels (post 2007) that the new owners
4 have assumed in deciding upon the purchase. A change in rates after so long a freeze will
5 constitute an important milestone for TEP. The Commission should have the ability to
6 make an assessment of the overall level of rate continuity or discontinuity that new
7 ownership is assuming. If some significant discontinuity is planned, it may bear upon the
8 merits of the requested transfer. Moreover, projections of rates provide an important
9 indicator of the ability of the new owners to make substantial paydowns in the increased
10 debt load that the consolidated enterprise will bear. Rates produce revenues, which
11 determine available cash flow for debt paydown.
12
13 New ownership will significantly increase debt at the holding-company level. It is
14 therefore important to validate that the revenue projections are sound. The revenue
15 projections should support a conclusion that debt repayment will leave the consolidated
16 entity in a situation that does not pose greater financial risks to utility operations than exist
17 today and that might be assumed to exist in the future, should no merger take place. They
18 should also produce comfort that the health of the new enterprise does not depend upon
19 unrealistic projections of future rates. Staff recognizes that projections are of necessity,
20 and are uncertain and somewhat speculative. This factor does not, however, make them
21 irrelevant in assessing potential consequences that may arise from a granting of the relief
22 that applicants have requested.
23
24 The applicants have spent much time and attention on revenue projections, which were
25 critical to their go/no-go decision about the transaction. It would be curious to find from

1 them an assertion that such projections have no bearing on assessing the customer interests
2 involved in the parallel decision that they have asked this Commission to make.
3
4 **Q. What significance does Staff attach to projections of operating expenses and capital**
5 **expenditures?**
6 A. Staff considers them equally important to revenue projections with respect to assessing
7 impacts on the financial strength of utility operations and their ability to get capital at
8 economical rates. It is the net of revenues and costs that will produce the cash flow from
9 which debt repayment will come. Therefore, there is the same interest in validating their
10 general reasonableness, recognizing that, like revenue projections, expense projections
11 require speculation and are prone to significant variance from what may actually happen.
12 This Commission, like the investors, must inform its decision here on a range of
13 assumptions about the future.
14
15 There is a second area where expense projections are critical to these proceedings. What
16 the new owners think about the potential for utility-related expenditure reductions (both
17 O&M and capital) is relevant to the questions, addressed elsewhere in this testimony,
18 about the potential for degradation of service quality and reliability.
19
20 **Q. What significance does Staff attach to projections of debt paydown and of financial**
21 **ratios?**
22 A. They show what the new owners believe to be the pace of debt reduction after the merger
23 and under a range of external circumstances (such as rate levels, interest rates, and sales
24 growth). Prompt, substantial debt reduction is the plan of the new owners and it is
25 moreover a very typical feature of leveraged buyouts such as this one. Seeing the owners

1 projections in these areas would provide important validation of two critical features:
2 ability and intention to make such paydowns if things go as planned and, as importantly, if
3 they do not go as well as planned.
4
5 Q. **Can we not rely upon the projections of revenues by UniSource?**
6 A. They are useful, but not determinative. Certainly the new owners do not consider them
7 so. The reason why this Commission should not do so is the same; current ownership's
8 views and its actions will not matter should the merger proceed. The key decisions will be
9 made under a different structure and leadership than the one that has made those
10 projections. What the new owners intend to do and what they envision are more
11 important.
12
13 Q. **But won't current management remain after the merger?**
14 A. First, it may be that it will, but there is no firm commitment to that effect. Second, even if
15 the current CEO and his senior team remain, the partnership agreement, the plans for
16 board of director changes, and the planning documents of the investors lead Staff to
17 conclude that there will likely be a substantial change in how decisions about budgets and
18 expenditures get made for the utilities involved in this transaction.
19
20 Specifically:
21 - There will no longer be a board of directors with substantial outside membership
22 (at the least there has been no commitment to retaining one).
23
24

Therefore, what the three limited partners foresee, what they plan, and what they are likely to do comprise the most pertinent forecasting elements now available with respect to what is likely to happen at the affected utilities across the coming years.

Q. Has Staff sought such information?

A. Yes, Staff served on UniSource Request S/L 10-130. That request, but not the response, is attached as Exhibit JA-4.

Q. Did the response to that request provide the information sought?

1 A. Not all of it; there were significant redactions. Claiming confidentiality, each of the three
2 investment groups made substantial redactions of discussions about future rates and of
3 balance sheet, income statement, and cash flow statement information necessary to give an
4 understanding of their views of future utility revenues and cash flow statements. They did
5 supply, however, extensive information showing projections about expected capital and
6 operating costs, along with key financial ratios. Therefore, much of the concern Staff had
7 about the initial redactions has been resolved. There does remain an area of potential
8 disagreement. Staff will address it below.
9

10 **Q. Based on what was provided, can Staff make any observations on the question of**
11 **validating internal investor expectations about rate continuity/discontinuity or the**
12 **relationship between revenue levels and the expected levels of debt repayment?**
13 A. No. The redactions of rate information made it impossible to make observations in this
14 area. Staff will therefore continue to seek the information.
15

16 **Q. Based on what was provided, can Staff make any observations on the question of**
17 **whether internal investor expectations regarding utility O&M and capital**
18 **expenditures are consistent with maintaining safe adequate and reliable service?**
19 A. Yes. To the extent that a brief review of this information could determine. We were
20 permitted only to examine previously redacted information in the week prior to the filing
21 of this testimony; we could not retain the information for any close examination. That
22 brief review disclosed no apparent indication of planned discontinuities in expenditures
23 from those that current UniSource management has made. The review also generally

1 showed a balance between growth projections (for load and inflation) and projected
2 expenditures. The review also demonstrated that all three of the investor groups made
3 reasonably similar projections. There are, however, limited questions remaining about
4 some diverging estimates of capital expenditures. Staff will continue to explore them.
5
6 **Q. Based on what was provided, can Staff make any observations on the question of**
7 **validating the reasonableness of debt repayment projections?**
8 A. Certain financial ratios previously redacted were provided at the same time as the cost
9 information. The same, brief review of those ratios disclosed no evident concerns, but the
10 lack of the supporting revenue information makes it difficult to make any particularly firm
11 observations on this issue.
12
13 **Q. What conclusions, if any, can Staff draw from the investor's responses about the**
14 **access-to-information issue you have discussed in this testimony?**
15 A. The request solicited information that one would expect a utility to provide on
16 Commission request, subject, of course, to appropriate disclaimers about its forward-
17 looking nature. The role of the three investment groups here, which is far different from
18 that of typical utility or holding-company stock purchasers, is such that Staff would expect
19 them to provide it as well. One set of investor concerns focused on what providing the
20 information would mean to disclosure of their investment strategies, models, or other
21 matters relating to their investment activities. Staff would not agree with any belief that
22 there should be a circumscribing of information provided to a state utility regulatory

commission because of such concerns. Our discussions to date have led to agreement that many redactions were appropriate. Similarly, investor representatives have agreed to supply much of the redacted information that we do consider relevant. Staff is hopeful of resolving remaining differences, but cannot predict what success we will have.

The other area of investor concern expressed is that one might: (a) observe what the investors' "worst-case" rate scenario was, (b) realize that they decided to go ahead even should this worst-case occur, and (c) decide that it was therefore appropriate to apply the worst-case rate levels regardless of what the otherwise "right" thing to do would be after the rate freeze. Staff did not find this justification for refusing information to be convincing. It effectively appears to spring from the premise that frank communication with the Commission and its stakeholders should be discouraged because some from among this group cannot be trusted to be objective and fair. This is not an encouraging indicator of the ability to maintain proper dialogue with the owners of three important Arizona utilities.

Staff does not presume to question the legitimacy of the concerns from the investors' perspective. Rather, Staff believes that the investors should be expected to find a way to prevent their other concerns from precluding the provision of information like that requested here. Staff is not yet comfortable in concluding that the investor responses to the question at issue have no bearing on what future communications with the new owners might be like. Staff awaits final resolution of the areas of remaining disagreement before drawing conclusions about materiality to merger approval.

Other Potential Issues

Q. Are the officers of UniSource going to be improperly enriched by the sale of the company?

A. The officers of UniSource stand to make substantial amounts if the transaction goes to completion. What they would gain is not atypical of such transactions. Customers should clearly not bear the costs of any of those payments. Beyond this limitation, should the Commission find the transaction (with or without conditions) to be in the public interest, acceptance of the granting of those rewards by and at the expense of shareowners is appropriate.

Q. Should the Commission be concerned about how well UniSource's stockholders will do if and when the acquisition goes through?

A. No, because state utility commissions generally are not concerned with the price of the stock of the utilities that they regulate. One principal exception would be in a case where extreme price movement might be an indicator of difficulty in attracting capital at competitive rates. This Commission is appropriately concerned with balancing the interests of customers and stockholders when it makes decisions, like in rate cases, and those decisions will ultimately affect the price of utility stock. But, if for other reasons the price of a utility's stock goes up or down, the Commission has no obligation to respond.

A principle in the industry is that customers should not be expected to share in the economic losses of shareowners when they are not sufficiently connected to rate and

service issues. In return for that benefit, customers should not take offense when gain results from factors that have not come at inappropriate customer expense. Should this transaction be conditioned as Staff believes appropriate, then Staff believes that there is no reason for concern about those gains.

Questions of Chairman Spitzer

Q. Chairman Spitzer questioned how the Commission could ensure that sufficient long-term utility investments will be made, given that the investors have implied that their ownership horizon is 6 to 8 years. Can Staff address this point?

A. Yes. The investment horizon to be expected here is an issue, given the fact that short-changing the network often does not produce customer-discernible impacts until years later. The applicants have made general statements about maintaining the quality of service, implying that they will make necessary investments to ensure that quality, but they have not made any firm commitments. Staff believes the Commission should specifically address the concern that the applicants could forgo capital investments and maintenance expenses in order to maximize cash flow from the utility short term. Elsewhere, this testimony discusses approval conditions that the Commission could apply to address this concern.

Q. Will the new holding company and its subsidiary utilities have the benefit of reduced costs that proponents of mergers often project?

A. No. This result is not surprising, because this is a reorganization and not a merger of separate entities performing like activities. Chairman Spitzer asked UniSource for confirmation of this and received it (response of March 19, 2004, 3.d). Chairman Spitzer also raised the question of those other cost reductions often associated with leveraged buyouts (response of March 19, 2004, 3.c). The Company's response to his question on this topic says that the Investors do not expect to reduce costs in ways that current UniSource management has not planned, and the only advantage they currently think they will bring is access to capital:

> The Investors also believe that the financial relationships and expertise they will contribute to UniSource Energy represent a valuable and previously unavailable capital resource that will produce future cost reductions. But, specifically, the Investors have no plans for cost reductions, spreading overhead or up sourcing or outsourcing of expenses beyond those currently contemplated in management's business plans.

These are topics that Staff has addressed in this testimony as a possible risk of reduction in the quality, reliability, and efficiency of the service that the utilities' customers can expect. Chairman Spitzer also asked about enhancements to revenues. The Company's answer offers reasonable expectations about increasing sales:

> After their own thorough investigation, the Investors are familiar and comfortable with current management strategies to maximize these marketing gains and strategic benefits associated with the markets served and have no plans of their own separate and distinct from those strategies.

Most utilities try to increase unit sales, but there are just not that many things they can do. Utilities that have sought growth beyond traditional regulated business have therefore often diversified into non-regulated businesses, with decidedly-mixed results.

1 **Q. Chairman Spitzer asked how the effects of strong cash flow needs after the merger**
2 **might affect the ability of the Commission to ensure that long-term investment**
3 **continues. Does Staff have any comments on that question or the applicants'**
4 **response to it?**
5 A. The Chairman's questions in this area get to the heart of an important issue in this case.
6 The leveraged nature of the LBO proposal does require a steady stream of dividends
7 upward from the utilities. Creating and maintaining that stream forms the foundation of
8 the proposed transaction structure. All of the other pieces of the transaction depend upon
9 those streams. The explicit nature of the details of a pledge by the UniSource entities to
10 the LBO structure and its debt-holders is unknown at this time, however. The Company
11 did not provide the specific pledge documents that comprise the exhibits to Saguaro's
12 $360 million secured debt financing in their response to Staff data request S/L 10-106.
13
14 The Chairman's discussion of whether the mandatory dividend flow from the utilities will
15 prevent a build-up of equity capital at the utilities reflects an important point in this
16 testimony. The projected level of TEP equity is expected to reach about 40 percent under
17 the LBO proposal, excluding capital leases in the capital structure. From a credit
18 perspective, however, the TEP equity capital percentage would reach only about 28
19 percent because of TEP's high levels of commitments to capital leases. Those leases are
20 considered to be debt in credit evaluations. The commitment of utility cash flow to
21 servicing the LBO structure makes further build-up of these still-low equity levels
22 unlikely in the foreseeable future.

Equally important to the financial health of the utilities is the protection of the utilities' equity levels after they are built up by the transaction. The proposed transaction does not prevent the future removal of funds and equity from the utility companies that could occur due to financial problems in other parts of the holding company or the LBO structure.

To ensure that long-term investment in the utilities continues post-acquisition, the equity capital and cash flow of the utility, its access to market (not LBO) capital, and its investment in utility operations must be specifically ensured. None of the specific protections for the utilities that would ensure the preservation of equity capital, improved access to market capital, and commitments to adequate dollar investment in utility operations have been included in the LBO proposal. The ring-fencing provisions identified in this testimony would provide such utility protection in each of these important areas.

Questions of Commissioner Hatch-Miller

Q. Please comment on Commissioner Hatch-Miller's question about the appropriateness of the LBO structure from a business, regulatory and public policy perspective.

A. In general, an LBO structure can provide an overall economic benefit to the acquirers, provided that a steady stream of "excess" utility cash flow can comfortably service the LBO debt. However, whether the LBO structure is appropriate from a regulatory and

public policy perspective depends on whether effective utility-entity protections are ensured.

This testimony discusses extensively the appropriate protections of UniSource utility equity capital, cash flow, assets, and operations. The risks from LBO leverage and other financial dangers within the post-merger structure can be mitigated substantially by the adoption of specific ring-fencing conditions to insulate the utilities. The applicants, however, have not included effective utility protections in the proposal before this Commission at the present time. In its proposed form, Staff believes that the LBO structure is inappropriate from a regulatory and public policy standpoint due to this lack of specific utility protections.

Q. Please comment on Commissioner Hatch-Miller's question about risk to TEP, UNS Electric, UNS Gas, and their customers from the heavy use of financial leverage at the holding-company level.

A. This testimony explains that the risks created by LBO debt have a negative impact on the credit standing of UniSource's utility subsidiaries. The existing LBO proposal does not adequately protect TEP or the UES utilities from the leverage of the LBO structure or from other financial problems within the holding company structure.

The rating agencies recognize that the transaction as proposed does not offer effective protections for the utility entities against the risks of LBO debt. The lack of such

1 protections allow the increased holding company leverage to negate or override the
2 positive effect of debt reduction at TEP.
3
4 **Q. Please comment on Commissioner Hatch-Miller's question about ownership of TEP,**
5 **UNS Electric, and UNS Gas by a private investor group that gains ownership by**
6 **taking on a high degree of debt.**
7 A. An acquisition that is financed with a high degree of debt is in the public interest only if
8 the utility entity and its operations can be effectively shielded from the risks of such debt.
9 Support for this conclusion is provided in the two previous answers and elsewhere in this
10 testimony, in those portions addressing the implications of private ownership on questions
11 of governance, transparency, and reporting.
12
13 **Q. Please comment on Commissioner Hatch-Miller's question about how approval of**
14 **this transaction might affect credit ratings.**
15 A. Credit rating agencies have indicated that the LBO transaction will be either negative or
16 neutral for the credit rating of TEP, not a positive impact. The positive credit implications
17 of the reduction in debt levels at TEP is negated or overridden by the negative credit
18 implications of the LBO leverage and lack of protections for TEP.
19
20 __Questions of Commissioner Mayes__
21 **Q. Does Staff have concerns about potential issues that this proposed reorganization has**
22 **for the future ratemaking for the UniSource utilities?**

1 A. Yes. Staff's general concern is that the utilities may seek to recover certain costs
2 associated with this potential reorganization. There are two types of costs that concern
3 Staff: termination fee and acquisition premium. In addition, as this testimony addresses
4 previously, the unwillingness of the investors to discuss their rate expectations with Staff
5 is also of concern.
6
7 **Q. What problem does the termination fee pose?**
8 A. As Commissioner Mayes has pointed out in her letter of March 24, 2004, if the proposed
9 reorganization does not go forward then UniSource must pay the Investors $25 million.
10 She has asked whether the UniSource utilities' customers could be liable for this expense.
11 They should not, as UniSource's stockholders approved this reorganization with full
12 disclosure of this fee. In addition, Staff beleives that customers should never be at risk of
13 bearing any part of the termination fee because neither they nor the Commission asked
14 UniSource to seek a new owner. Thus, any risk of the fee should be solely that of the
15 current owners of UniSource, who are the ones who reap the rewards associated with
16 transfer of their ownership interest.
17
18 **Q. How has UniSource proposed to treat the acquisition premium associated with this**
19 **proposed reorganization in future rate proceedings for the utilities?**
20 A. Mr. Pignatelli's testimony was silent about this question. Staff asked about plans in this
21 regard. The Company's response to S/L 10-103 (see Exhibit JA-5) was limited to TEP's
22 2004 rate case, which does not bear on the question, because the new owners will not have

1 incurred the acquisition premium as of the filing of that case, and because the case cannot
2 result in an increase in any event.
3
4 The issue is broader than just TEP's June filing. The three utilities' rate freezes will
5 eventually end, and some amortized balances of acquisition premiums could be "pushed
6 down" from the holding company to the balance sheets of the utilities. Thus, the more
7 significant issue, which the response to S/L 10-103 does not address, is what will happen
8 at that time.
9
10 **Q. Would the pushing down of the acquisition premium to the books of the utilities be**
11 **wrong?**
12 A. Yes, because if that were done then in the utilities' next rate cases there would be an open
13 issue as to whether customers' rates should include the return of, and return on, those extra
14 tens or hundreds of millions of dollars. Neither customers nor the Commission asked
15 UniSource to seek a new owner, and if the Investors pay more for the assets of UniSource
16 than their book value that is their decision. Therefore, Staff recommends that the
17 Commission condition its approval of the proposed transaction on an order that none of
18 the utilities may ever recover any portion of an acquisition premium or associated costs of
19 the transaction from their customers.
20
21 **Q. If the Commission accepts your recommendation about the acquisition premium, will**
22 **it be setting a policy that will deter other mergers that might benefit customers?**

1 A. No. In the case of a merger in which customers will realize savings that are due to
2 efficiencies, the proponents of such a merger can argue that customers can help pay for
3 some of the costs, like the acquisition premium, and the Commission can then judge the
4 merits of the proposed bargain.
5
6 **Q. This testimony addressed the issue of affirmative commitment to maintaining**
7 **UniSource's headquarters in Tucson. Does Staff have a similar recommendation on**
8 **employee levels?**
9 A. No, Staff does not. Concern about the maintenance of employment levels is a matter of
10 valid public concern. Staff does not think that the Commission should condition this
11 proposed reorganization on specific guarantees for utility employees. This is not a merger
12 that brings together two independently operating line and support staffs. Therefore, there
13 is not substantial potential for job reductions through combining staffs. For the same
14 reasons, there is not a substantial, apparent occasion for moving jobs out of Arizona,
15 particularly if the Commission conditions any approval of the merger on retention of
16 office locations.
17
18 Therefore, what remains is the potential that already exists at UniSource; *i.e.*,
19 management's identification of opportunities to improve efficiency. As UniSource
20 currently remains free to reduce staffing in that fashion, so does, and so should, the new
21 owners. There exist, of course, the added cost-reduction pressures associated with a

leveraged buyout. Response to these pressures could take the form of staffing reductions. However, this testimony earlier addressed that issue.

In summary, we do not believe that there should be an express condition addressing minimum employee levels. Recognizing, however, that job cuts are a prime source of future cost reductions, we consider it all the more important to include a condition requiring a post-merger management and operations review. That review can and should include an assessment of the sufficiency of employee levels, and an examination of employee reductions, if any, already taken or planned by the time of that audit.

Q. Does this conclude your direct testimony?

A. Yes.

APPENDIX A: PRIOR REGULATORY PROCEEDINGS IN WHICH JOHN ANTONUK HAS PARTICIPATED

1. The New Jersey Board of Public Utilities (BPU) as part of its investigation of NUI's finances, governance, affiliate transactions, controls, and compliance with the conditions established by the BPU in allowing the formation of a holding company. My role there was to manage a focused audit to address the matters listed above and to advise the BPU on interim actions necessary to assure that significant financial difficulties at the holding company did not cause a failure of Elizabethtown Gas to continue to deliver safe, reliable, and adequate service to its many retail customers in Northern New Jersey.
2. The New Hampshire Public Utilities Commission regarding the agreement that settled the restructuring of Public Service Company of New Hampshire (DR 99-099).
3. The New Hampshire Public Utilities Commission regarding the merger of NU and CEI (DE 00-009).
4. The Pennsylvania Public Utility Commission regarding test-year expense adjustments for various findings, conclusions, and recommendations from Liberty's management and operations audit of West Penn Power Company.
5. The Tennessee Public Service Commission regarding the rate-case implications of various findings, conclusions, and recommendations from Liberty's management and operations audit of United Cities Gas Company.

6. The Maryland Public Service Commission regarding the rate-case implications of Liberty's audit of the affiliate relationships and transactions of C&P Telephone Company of Maryland (now Verizon Maryland).
7. The Maryland Public Service Commission regarding the rules of conduct that should apply to relationships between Baltimore Gas & Electric Company and its affiliates in the energy business.
8. The Virginia State Corporation Commission regarding a variety of matters at issue in arbitrations between major competitive local exchange service providers (including AT&T, MCI, and Sprint) and Bell Atlantic.
9. The Illinois Commerce Commission on the fuel-procurement practices and decisions of Central Illinois Public Service Company.
10. The Massachusetts Department of Telecommunications and Energy regarding competitive, market, and affiliate-relationship issues concerning Boston Edison's entry into non-traditional businesses, including energy marketing and services and telecommunications, as a consultant to Boston Edison.
11. The Public Utilities Commission of Ohio, regarding the findings and conclusions reached by Liberty in its audit of Ameritech retail service performance quality and performance quality measurement.
12. Wyoming Public Service Commission regarding the gas procurement and transportation practices of K N Energy.

13. The Colorado, Wyoming, and Utah public service commissions regarding the status of a performance measures audit and performance data reconciliation related to Qwest 271 OSS testing.
14. Maryland Public Service Commission, regarding the Code of Conduct adopted as part of the BG&E/PEPCO merger.
15. The Virginia Corporation Commission concerning separate arbitrations involving five CLECS and Bell Atlantic and GTE.
16. Service as an arbitrator, facilitator, or administrative law judge on a contract basis in the following state commission proceedings under the Telecommunications Act of 1996:
    - AT&T/USWest interconnection agreement arbitration agreement: Idaho Public Utilities Commission
    - AT&T/GTE interconnection agreement arbitration agreement: Idaho Public Utilities Commission
    - Interconnection agreement arbitrations involving two small CLECs and Qwest: Idaho Public Utilities Commission
    - AT&T/Bell South interconnection agreement arbitration: Mississippi Public Service Commission
    - Qwest Section 271 Checklist Compliance, Separate Affiliate, Public Interest, and Existence of Local Competition Issues: Idaho, Iowa, Montana, New Mexico, North Dakota, Utah, and Wyoming public service commissions

1 • Sufficiency of Qwest Performance Assurance Plan related to Section 271 entry: Idaho,
2 Iowa, Montana, New Mexico, Nebraska, North Dakota, Washington, and Wyoming
3 public service commissions
4 • Small CLEC issues forum in connection with state review of Qwest 271 petition:
5 Montana Public Service Commission
6 • Billing complaints by three paging companies against Qwest: Idaho Public Utilities
7 Commission.
8
9 17. Service as an advisor to commissioners, administrative law judges, and arbitrators in a number
10 of other state proceedings related to the Telecommunications Act of 1996:
11 • Global settlement of interconnection, universal service funding, and related issues
12 involving all ILECs and CLECs: Pennsylvania Public Utility Commission
13 • Three separate ILEC interconnection agreement arbitrations with Bell Atlantic: New
14 Jersey Board of Public Utilities
15 • Bell Atlantic SGAT and UNE price and access proceedings: Virginia Corporation
16 Commission
17 • Nine separate arbitrations over seven years, involving Bell Atlantic: Delaware Public
18 Service Commission
19 • Bell Atlantic Collocation proceedings: Delaware Public Service Commission
20 • Verizon 271 entry: Delaware Public Service Commission
21 • Verizon 271 entry: District of Columbia Public Service Commission.

1

Liberty Work Descriptions

2 **1. NUI**

3 For the New Jersey Board of Public Utilities (BPU), I managed a focused audit of NUI
4 Corporation and its operating utility companies. This audit included detailed examinations of the:

5 - Company's compliance with the conditions of the BPU order that allowed formation
6 of a holding company
7 - Sufficiency of those conditions to protect the public interest in light of the conduct and
8 activities of the holding company, its non-utility affiliates, and its utility operations
9 - Reasons why utility credit ratings fell to substantially below investment grade
10 - Impact of weakened financial condition on capital costs
11 - Need and means for insulating utility credit and financial strength from that of the
12 parent and the non-utility affiliates
13 - Kinds of ring-fencing of utility finances warranted in light of the parent's financial
14 condition
15 - Use of common cash pools by utility and non-utility operations
16 - Direct and indirect use of utility financial strength to support non-utility capital
17 acquisition
18 - Financial, accounting, payroll, receivables, and payables controls
19 - Affiliate transactions
20 - Corporate structure, governance, and compensation at the executive and director levels
21 - Arms'-length nature of energy trading operations involving utility operations and the
22 non-utility energy brokering operation of an affiliate.

1 **2. Consolidated Edison/Northeast Utilities merger.**

2 For the Governor of the State of New Hampshire, I testified about the public interest and potential
3 harm issues arising from the proposed merger of Northeast Utilities and Consolidated Edison.
4 That testimony addressed the kinds of risks that the merger created and it addressed the conditions
5 appropriate to mitigation of those risks sufficiently to support a finding that the proposed merger
6 was in the public interest.

7 **3. Competitive Services of New Jersey Electric Utilities**

8 I managed Liberty's audits of the competitive services of the four major New Jersey electric
9 utilities (including one of the country's largest retail electricity suppliers, PSE&G, which also
10 serves as a local distribution gas utility). This audit addressed code-of-conduct issues, use of
11 customer information by affiliates, affiliate transactions, cost allocations and assignment,
12 commingling of financial resources and credit, and a number of other issues associated with
13 utility operations within a holding company structure. Three New Jersey retail electric utilities
14 operate as part of multi-state holding company operations, which include:

15 - Consolidated Edison, which serves over 3.3 million electric customers and more than
16 1.2 million gas customers in New York, Pennsylvania, and New Jersey
17 - First Energy, which serves 4.4 million electric customers through seven operating
18 companies in Ohio, Pennsylvania, and New Jersey
19 - Pepco Holdings, which distributes electricity and natural gas to some 1.8 million
20 customers in the Mid-Atlantic region, from New Jersey to Virginia.

21 **4. Commonwealth Edison Service Quality and Reliability**

1 I led an extensive review for the Illinois Commerce Commission of the costs of a massive capital
2 and O&M "catch-up" spending program adopted by Commonwealth Edison to respond to a major
3 series of service disruptions in the City of Chicago. This review included:

4 • Detailed analyses of capital and operating expenditure trends within the company and
5 in comparison to those of its peers
6 • Extensive reviews of service quality drivers, such as numbers of open maintenance
7 items and productivity over an extended period
8 • Impacts of externally caused financial constraints on transmission, distribution, and
9 customer service programs and expenditures
10 • Capital project and maintenance program design, planning, and execution.

11 **5. Public Service Electric & Gas.**

12 About a decade ago Liberty performed one of the country's first detailed examinations of
13 holding-company operations for a state utility regulatory commission. This focused audit of
14 PSE&G for the New Jersey Board of Public Utilities:

15 • Addressed performance of utility and non-utility affiliates after holding company
16 formation
17 • Examined the effects of poor non-utility affiliate performance on utility finances and
18 financial health
19 • Included a detailed review of affiliate transactions, which included competitive energy
20 supply businesses, costs, allocations, provision of central services, executive
21 management and governance.

22 **6. Dominion Resources and Virginia Power.**

1 I managed Liberty's examination, for the Virginia State Corporation Commission of the
2 circumstances underlying the open and notorious dispute between the board and executive
3 management of the Commonwealth's largest electricity supplier, Virginia Power, and its
4 counterparts at Dominion Resources, which owned the utility. This examination included
5 executive and board structure and operations, the degree to which utility independence of
6 operation (vis-à-vis the holding company) was necessary to promote the public interest, affiliate
7 transactions, and financial, capital, and operational planning, budgeting, and execution.

8 **7. Management and Operations Audits and Affiliate Examinations**

9 I have managed many Liberty management and operations audits for the commissions of
10 Pennsylvania, New York, Connecticut, Tennessee, Kentucky, and New Hampshire. These major
11 engagements have examined a number of multi-state holding company or utility operations,
12 Verizon, GTE, Northeast Utilities, and United Cities Gas, a multi-state gas distribution utility
13 later acquired by Atmos. These audits have also included a number of then stand-alone utilities,
14 examples of which include New York State Electric & Gas, Central Hudson Gas & Electric,
15 Yankee Gas, Southern Connecticut Gas, and Connecticut Natural Gas. These engagements
16 typically have included reviews of governance, executive management, planning and budgeting,
17 operations, finance, and affiliate costs, which are among the issues I address in this testimony.
18

19 My work at Liberty also includes management of many engagements addressing affiliate
20 transactions and costs as either a major or sole area of audit focus.

UniSource Energy Corporation's
Responses To Staff's 6th Set Of Data Requests
Docket No. E-04230A-03-0933
March 18, 2004

JMR 6-89: Refer to the Company's response to Staff data request JMR 4-83. Does the Company agree with Fitch's characterization of Section 305(a) of the Federal Power Act as limiting dividends to a utility's net income? Please provide an explanation if the Company interprets the provision differently.

RESPONSE: Yes, if the utility has an accumulated deficit instead of a positive balance of retained earnings.

RESPONDENT: Kevin Larson
One South Church Avenue
Tucson, Arizona 85701

Exhibit JA-2

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

JMR 3-67: Please provide a summary of A.A.C. R14-2-801 through 806 waivers previously granted to UniSource and state whether the Company believes any such waivers will apply to Saguaro Utility Group I Corp. and why.

RESPONSE: The Commission authorized Tucson Electric Power Company to organize UniSource Energy Company in Decision No. 60480. (November 25, 1997).

Attached hereto is Commission Decision Nos. 62103, Bates Nos. UEC000715 to UEC000759, in which waivers to the Affiliated Interest Rules (AAC R14-2-801 et seq.) were granted to UniSource Energy Company.

UniSource Energy believes that as a result of the Merger, the waivers will continue to apply to UniSource Energy. Any waivers to the Affiliated Interest Rules needed by Saguaro Utility Group I Corp. will be presented to the Commission for approval unless the Commission indicates that any such waivers are unnecessary.

RESPONDENT: Vincent Nitido
One South Church Avenue
Tucson, Arizona 85701

UniSource Energy Corporation's
Responses To Staff/Liberty's 10th Set Of Data Requests
Docket No. E-04230A-03-0933
April 19, 2004

S/L 10-134 Please provide the proposed composition of the Board of Directors for TEP following the merger.

RESPONSE: The proposed composition of the Board of Directors for TEP following the merger has not yet been discussed by the parties.

RESPONDENT: Vincent Nitido
One South Church Avenue
Tucson, Arizona 85701

UniSource Energy Corporation's
Responses To Staff/Liberty's 10th Set Of Data Requests
Docket No. E-04230A-03-0933
April 19, 2004

S/L 10-130	Please provide the presentations that the Investors made to their own boards of directors, and/or investors or investment committees or the like to obtain their approval for entering into the Merger.
RESPONSE:	See letter from UniSource Energy counsel to Staff's counsel dated April 15, 2004. UniSource and Staff have agreed that responsive documents will be produced for review by Staff's consultants, pursuant to the terms of the Protective Agreement dated January 21, 2004.
RESPONDENT:	Vincent Nitido One South Church Avenue Tucson, Arizona 85701

UniSource Energy Corporation's
Responses To Staff/Liberty's 10th Set Of Data Requests
Docket No. E-04230A-03-0933
April 19, 2004

S/L 10-103 Please provide documents that show how the new company will or will not to seek to recover an acquisition premium in the next rate cases of any of the utility subsidiaries.

RESPONSE: There are no documents that show how the new company will or will not seek to recover an acquisition premium in the next rate case of any of the utility subsidiaries. TEP's 2004 rate case is anticipated to be filed in June, 2004, and will not seek recovery of any acquisition premium for this transaction. See response to RUCO 2.1, 2.2 and 2.3.

RESPONDENT: Vincent Nitido
One South Church Avenue
Tucson, Arizona 85701