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ARIZONA CORPORATION COMMISSION

Brian C. McNeil
Executive Secretary

Direct Line: (602) 542-4143
Fax: (602) 542-0765
E-mail kmayes@cc.state.az.us

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Chairman Marc Spitzer
Commissioner William A. Mundell
Commissioner Mike Gleason
Commissioner Jeff Hatch-Miller
All Parties in Docket No. E-04230A-03-0933: In Matter of the Reorganization of UniSource Energy Corporation

Re: Proposed UniSource Energy Services/KKR Merger; Docket No. E-04230A-03-0933: In Matter of the Reorganization of UniSource Energy Corporation

Dear Colleagues and Parties:

The filed testimony of UniSource President James Pignatelli and UniSource Energy's Proxy Statement to its shareholders have-raised several questions that I believe warrant immediate exploration and answer.

First, the filed testimony of Mr. Pignatelli notes that if this Commission, the Federal Energy Regulatory Commission or the Securities and Exchange Commission fail to approve the proposed merger, UniSource, by the terms of the proposed agreement, will have to pay up to $25 million in fees to KKR and the other investors proposing to purchase UniSource.[1] Mr. Pignatelli's testimony hints that these fees were at least the subject of some discussion by the Strategic Transaction Advisory Committee.[2] This termination fee raises serious questions, including:

- What does the $25 million represent? At first blush, it would seem far too much to represent the legal fees of KKR. How was this figure arrived at?

[1] See UES Proxy Statement pgs 4 and 52; see also Direct Testimony of James S. Pignatelli on Behalf of UniSource Energy Corporation, pg. 16, stating that "On November 19, 2003, the Investors accepted our proposal. In particular, the Investors agreed to a purchase price of $25.25 per share and termination fees and expenses in an amount up to $25 million in the aggregate on the terms stated in the acquisition agreement."

[2] See Pignatelli testimony, pg. 12, stating that "At its meeting on October 29, 2003, the Strategic Transaction Advisory Committee also received an update from me regarding certain of Millenium Energy Holding, Inc.'s investments. . .The Committee, in consultation with its counsel and representatives of New Harbor also identified certain issues in connection with the transaction, including price, regulatory conditions, financing of the transaction, and the request by the Investors for reimbursement of expenses if the acquisition failed to receive regulatory approval."

- What concerns, if any, were raised by the Strategic Transaction Advisory Committee about the size of this termination fee, and were there discussions by the Committee about passing those fees along to ratepayers?
- If the ACC does not approve the Merger, who will pay the $25 million? Will that cost be borne by shareholders, or is it more likely that UniSource will ask the ACC to pass that cost on to ratepayers? Isn't this a potential drain on UES' ability to raise capital, since they could become $25 million poorer?
- Does UniSource's Board of Directors have the authority to agree to this provision, absent ACC approval, given that the potential $25 million hit would most likely affect ratepayers at some point?
- Should the ACC be forced to make the Hobson's choice between approving the Merger or watching the ratepayers of UniSource be subjected to a potential $25 million hit?
- What precedent is there for such a large termination fee that is triggered by the actions of regulators in a case involving the proposed sale of a utility?

Second, while UniSource and KKR have averred that there will be no changes in upper-level management of the company, in the company's corporate charitable giving, or in the company's physical headquarters, there are no promises made either in the proxy statement or in Mr. Pignatelli's filed testimony regarding the job security of UES rank-and-file employees. I would like to know whether the Investors intend to outsource any of the company's current operations, and whether there would be any post-Merger changes in employee benefits.

Third, the proposed Merger has obvious implications for ratepayers beyond those already expressed. TEP is currently subject to a rate freeze until 2008 and UNS is subject to a rate freeze until 2007. Do the Investors intend, or have they discussed, proposing a rate increase after that freeze is lifted?

Fourth, UES professes to have done a great deal of due diligence and preparation in advance of its filing with the Commission. As such, I would like to know whether the company investigated any of the 110 previous deals conducted by KKR, including its 2003 purchase of Detroit Edison. If an investigation of that deal was done, what was learned? In particular, was there a termination fee associated with that buy-out?

Fifth, I would like to know why, in this case, UES' Board of Directors chose to seek shareholder approval prior to gaining the regulatory approval of the ACC, the FERC and the SEC. In many cases, companies seeking merger will generally first secure the necessary sign-off of regulators prior to making a pitch to shareholders.

Sixth, I share the concerns voiced by my fellow Commissioners regarding the degree to which this deal may spell trouble for the company's ability to sustain future investment. Growth projections for UES' service territory are robust, and yet the leveraged nature of the deal seems to require a post-merger company to make cash flow to the holding company a priority. Will the post-merger corporation make the kinds of investments necessary to keep up with service demands, and will it promise to maintain all projects currently in the works? Specifically, do the Investors intend to follow through with the construction of Units 3 and 4 of the Springerville

plant? Do the Investors intend, or have they ever discussed, the possibility of selling UES prior to the seven year average holding period for KKR investments? Have they ever discussed the idea of purchasing other utilities in the region, combining them with UES and thereby "regionalizing them" and then selling them as a package in order to maximize profits?

I ask the parties to consider and address these issues so that the Commission will have the benefit of a well-developed record on these questions.

Sincerely,

Kristin K. Mayes
Commissioner