TUCSON ELECTRIC POWER CO
Form 10-Q
April 29, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2013

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

| Commission File Number | Registrant; State of Incorporation; Address; and Telephone Number | IRS Employer Identification Number |
|---|---|---|
| 1-13739 | UNS ENERGY CORPORATION<br>(An Arizona Corporation)<br>88 East Broadway Boulevard<br>Tucson, AZ 85701<br>(520) 571-4000 | 86-0786732 |
| 1-5924 | TUCSON ELECTRIC POWER COMPANY<br>(An Arizona Corporation)<br>88 East Broadway Boulevard<br>Tucson, AZ 85701<br>(520) 571-4000 | 86-0062700 |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

| | | |
|---|---|---|
| UNS Energy Corporation | Yes x | No ¨ |
| Tucson Electric Power Company | Yes x | No ¨ |

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

| | | |
|---|---|---|
| UNS Energy Corporation | Yes x | No ¨ |
| Tucson Electric Power Company | Yes x | No ¨ |

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

| | | | | |
|---|---|---|---|---|
| UNS Energy Corporation | Large Accelerated Filer | x | Accelerated Filer | ¨ |
| | Non-accelerated Filer | ¨ | Smaller Reporting Company | ¨ |
| Tucson Electric Power Company | Large Accelerated Filer | ¨ | Accelerated Filer | ¨ |
| | Non-accelerated Filer | x | Smaller Reporting Company | ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

| | | |
|---|---|---|
| UNS Energy Corporation | Yes ¨ | No x |
| Tucson Electric Power Company | Yes ¨ | No x |

As of April 17, 2013, 41,459,272 shares of UNS Energy Corporation Common Stock, no par value (the only class of Common Stock), were outstanding. As of April 17, 2013, Tucson Electric Power Company had 32,139,434 shares of common stock outstanding, no par value, all of which were held by UNS Energy Corporation.

This combined Form 10-Q is separately filed by UNS Energy Corporation and Tucson Electric Power Company. Information contained in this document relating to Tucson Electric Power Company is filed by UNS Energy Corporation and separately by Tucson Electric Power Company on its own behalf. Tucson Electric Power Company makes no representation as to information relating to UNS Energy Corporation or its subsidiaries, except as it may relate to Tucson Electric Power Company.

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DEFINITIONS

The abbreviations and acronyms used in the 2013 first quarter report on Form 10-Q are defined below:

| | |
|---|---|
| 1992 Mortgage | TEP's Indenture of Mortgage and Deed of Trust, dated as of December 1, 1992, to the Bank of New York Mellon, successor trustee, as supplemented |
| 2010 TEP Reimbursement Agreement | Reimbursement Agreement, dated December 14, 2010, between TEP, as borrower, and a financial institution |
| 2010 UNS Electric Rate Order | A rate order issued by the ACC resulting in a new rate structure for UNS Electric, effective September 1, 2010 |
| 2013 Settlement Agreement | The proposed settlement agreement between TEP, ACC Staff, and parties to the pending rate case which requires approval of the ACC before rates can become effective |
| ACC | Arizona Corporation Commission |
| ALJ | Administrative Law Judge |
| AOCI | Accumulated Other Comprehensive Income |
| APS | Arizona Public Service Company |
| BART | Best Available Retrofit Technology |
| Base O&M | A non-GAAP financial measure that represents the fundamental level of operating and maintenance expense related to our business |
| Base Rates | The portion of TEP's and UNS Electric's Retail Rates attributed to generation, transmission, distribution costs, and customer charge; and UNS Gas' delivery costs and customer charge. Base Rates exclude costs that are passed through to customers for fuel and purchased energy costs |
| BMGS | Black Mountain Generating Station |
| Btu | British thermal unit(s) |
| Capacity | The ability to produce power; the most power a unit can produce or the maximum that can be taken under a contract, measured in megawatts |
| CC&N | Certificate of Convenience and Necessity |
| Common Stock | UNS Energy Corporation's common stock, without par value |
| Company | UNS Energy Corporation and its subsidiaries |
| Convertible Senior Notes | UNS Energy Corporation's 4.5% Convertible Senior Notes |
| DSM | Demand Side Management |
| ECA | Environmental Compliance Adjustor |
| Electric EE Standards | Electric Energy Efficiency Standards |
| Energy | The amount of power produced over a given period of time measured in megawatt-hours |
| EPA | Environmental Protection Agency |
| EPS | Earnings Per Share |
| ESP | Electric Service Providers |
| FERC | Federal Energy Regulatory Commission |
| FIP | Federal Implementation Plan |
| FVRB | Fair Value Rate Base |
| Four Corners | Four Corners Generating Station |
| GAAP | Generally Accepted Accounting Principles |
| Gas EE Standards | Gas Energy Efficiency Standards |
| GBtu | Billion British thermal units |
| GWh | Gigawatt-hour(s) |
| Heating Degree Days | An index used to measure the impact of weather on energy usage calculated by subtracting the average of the high and low daily temperatures from 65 |
| IRS | Internal Revenue Service |

| | |
|---|---|
| kV | Kilo-volt |

v

| | |
|---|---|
| kWh | Kilowatt-hour(s) |
| LFCR | Lost Fixed Cost Recovery Mechanism |
| LOC | Letter of Credit |
| LIBOR | London Interbank Offered Rate |
| Millennium | Millennium Energy Holdings, Inc., a wholly-owned subsidiary of UNS Energy Corporation |
| MMBtu | Million British thermal units |
| Mortgage Bonds | Mortgage Bonds issued under the 1992 Mortgage |
| MW | Megawatt(s) |
| MWh | Megawatt-hour(s) |
| Navajo | Navajo Generating Station |
| Net Cash Flows after Capital Expenditures | A non-GAAP financial measure that compares capital expenditures relative to cash flows from operating activities |
| Net Cash Flows after Capital Expenditures and Required Payments on Capital Lease Obligations | A non-GAAP financial measure that compares capital expenditures and required payments on capital lease obligations relative to cash flows from operating activities |
| NSP | Negotiated Sales Program |
| NTUA | Navajo Tribal Utility Authority |
| NOx | Nitrogen Oxide |
| O&M | Operations and Maintenance |
| OATT | Open Access Transmission Tariff |
| OCRB | Original Cost Rate Base |
| PBI | Performance-Based Incentives paid to retail customers with solar installations based on metered renewable energy production over periods of 10 to 20 years |
| PGA | Purchased Gas Adjustor, a Retail Rate mechanism designed to recover the cost of gas purchased for retail gas customers |
| PNM | Public Service Company of New Mexico |
| PNMR | PNM Resources, Incorporated, PNM’s parent company |
| PPA | Power Purchase Agreement |
| PPFAC | Purchased Power and Fuel Adjustment Clause |
| PSD | Prevention of Significant Deterioration |
| REC | Renewable Energy Credit |
| RES | Renewable Energy Standard |
| Retail Margin Revenues | A non-GAAP financial measure that demonstrates the underlying revenue trend and performance of our core utility businesses |
| Regional Haze Rules | Rules promulgated by the EPA to improve visibility at national parks and wilderness areas |
| Retail Rates | Rates designed to allow a regulated utility an opportunity to recover its reasonable operating and capital costs and earn a return on its utility plant in service |
| Rules | Retail Electric Competition Rules established by the ACC in 1999 |
| San Juan | San Juan Generating Station |
| SCR | Selective Catalytic Reduction |
| SEC | Securities and Exchange Commission |
| SERP | Supplemental Executive Retirement Plan |
| SES | Southwest Energy Solutions, a wholly-owned subsidiary of Millennium |
| SJCC | San Juan Coal Company |

| | |
|---|---|
| SMCRA | Surface Mine Control and Reclamation Act |
| SNCR | Selective Non-Catalytic Reduction |
| SO2 | Sulfur Dioxide |

| | |
|---|---|
| Springerville | Springerville Generating Station |
| Springerville Common Facilities | Facilities at Springerville used in common by all four Springerville units |
| Springerville Common Facilities Leases | Leveraged lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities |
| Springerville Unit 1 | Unit 1 of the Springerville Generating Station |
| Springerville Unit 1 Leases | Leveraged lease arrangement relating to Springerville Unit 1 and an undivided one-half interest in certain Springerville Common Facilities |
| Springerville Unit 2 | Unit 2 of the Springerville Generating Station |
| Springerville Unit 3 | Unit 3 of the Springerville Generating Station |
| Springerville Unit 4 | Unit 4 of the Springerville Generating Station |
| SRP | Salt River Project Agricultural Improvement and Power District |
| Sundt | H. Wilson Sundt Generating Station |
| Sundt Unit 4 | Unit 4 of the H. Wilson Sundt Generating Station |
| TCA | Transmission Cost Adjustor |
| Tenth Circuit | United States Court of Appeals |
| TEP | Tucson Electric Power Company, the principal subsidiary of UNS Energy Corporation |
| TEP Credit Agreement | Second Amended and Restated Credit Agreement between TEP and a syndicate of banks, dated as of November 9, 2010 (as amended) |
| TEP Revolving Credit Facility | Revolving credit facility under the TEP Credit Agreement |
| Therm | A unit of heating value equivalent to 100,000 Btus |
| Tri-State | Tri-State Generation and Transmission Association, Inc. |
| UED | UniSource Energy Development Company, a wholly-owned subsidiary of UNS Energy Corporation |
| UES | UniSource Energy Services, Inc., a wholly-owned subsidiary of UNS Energy, and intermediate holding company established to own the operating companies UNS Gas and UNS Electric |
| UNS Credit Agreement | Second Amended and Restated Credit Agreement between UNS Energy Corporation and a syndicate of banks, dated as of November 9, 2010 (as amended) |
| UNS Electric | UNS Electric, Inc., a wholly-owned subsidiary of UES |
| UNS Energy | UNS Energy Corporation (formally known as UniSource Energy Corporation) |
| UNS Gas | UNS Gas, Inc., a wholly-owned subsidiary of UES |
| UNS Gas/UNS Electric Revolver | Revolving credit facility under the Second Amended and Restated Credit Agreement among UNS Gas and UNS Electric as borrowers, UES as guarantor, and a syndicate of banks, dated as of November 9, 2010 (as amended) |

Report of Independent Registered Public Accounting Firm
To the Board of Directors and Stockholders of
UNS Energy Corporation:

We have reviewed the accompanying condensed consolidated balance sheet of UNS Energy Corporation and its subsidiaries (the “Company”) as of March 31, 2013, and the related condensed consolidated statements of income for the three-month periods ended March 31, 2013 and 2012, the condensed consolidated statements of comprehensive income for the three-month periods ended March 31, 2013 and 2012, the condensed consolidated statement of changes in stockholders’ equity for the three-month period ended March 31, 2013 and the condensed consolidated statements of cash flows for the three-month periods ended March 31, 2013 and 2012. These interim financial statements are the responsibility of the Company’s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet and statement of capitalization as of December 31, 2012, and the related consolidated statements of income, comprehensive income, cash flows, and changes in stockholders’ equity for the year then ended (not presented herein), and in our report dated February 26, 2013, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information and consolidated statement of changes in stockholders' equity information as of December 31, 2012, is fairly stated in all material respects in relation to the consolidated balance sheet and consolidated statement of changes in stockholders' equity from which it has been derived.

/s/ PricewaterhouseCoopers LLP
PricewaterhouseCoopers LLP
Phoenix, Arizona
April 29, 2013

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholder of
Tucson Electric Power Company:

We have reviewed the accompanying condensed consolidated balance sheet of Tucson Electric Power Company and its subsidiaries (the “Company”) as of March 31, 2013, and the related condensed consolidated statements of income (loss) for the three-month periods ended March 31, 2013 and 2012, the condensed consolidated statements of comprehensive income (loss) for the three-month periods ended March 31, 2013 and 2012, the condensed consolidated statement of changes in stockholder’s equity for the three-month period ended March 31, 2013 and the condensed consolidated statements of cash flows for the three-month periods ended March 31, 2013 and 2012. These interim financial statements are the responsibility of the Company’s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet and statement of capitalization as of December 31, 2012, and the related consolidated statements of income, comprehensive income, cash flows, and changes in stockholder's equity for the year then ended (not presented herein), and in our report dated February 26, 2013, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information and consolidated statement of changes in stockholder's equity information as of December 31, 2012, is fairly stated in all material respects in relation to the consolidated balance sheet and consolidated statement of changes in stockholder's equity from which it has been derived.

/s/ PricewaterhouseCoopers LLP
PricewaterhouseCoopers LLP
Phoenix, Arizona
April 29, 2013

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PART I—FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (Unaudited) Thousands of Dollars (Except Per Share Amounts) | |
| Operating Revenues | | |
| Electric Retail Sales | $220,860 | $205,431 |
| Electric Wholesale Sales | 34,398 | 33,617 |
| Gas Retail Sales | 50,988 | 50,209 |
| Other Revenues | 25,895 | 26,130 |
| Total Operating Revenues | 332,141 | 315,387 |
| Operating Expenses | | |
| Fuel | 81,689 | 70,735 |
| Purchased Energy | 64,159 | 59,790 |
| Transmission | 3,186 | 2,826 |
| Increase (Decrease) to Reflect PPFAC/PGA Recovery Treatment | (5,368) | (2,561) |
| Total Fuel and Purchased Energy | 143,666 | 130,790 |
| Operations and Maintenance | 89,901 | 94,317 |
| Depreciation | 36,300 | 34,984 |
| Amortization | 8,289 | 8,664 |
| Taxes Other Than Income Taxes | 14,090 | 12,229 |
| Total Operating Expenses | 292,246 | 280,984 |
| Operating Income | 39,895 | 34,403 |
| Other Income (Deductions) | | |
| Interest Income | 10 | 258 |
| Other Income | 2,805 | 3,095 |
| Other Expense | (572) | (466) |
| Total Other Income (Deductions) | 2,243 | 2,887 |
| Interest Expense | | |
| Long-Term Debt | 18,254 | 19,135 |
| Capital Leases | 6,249 | 8,296 |
| Other Interest Expense, Net of Interest Capitalized | (1,068) | 175 |
| Total Interest Expense | 23,435 | 27,606 |
| Income Before Income Taxes | 18,703 | 9,684 |
| Income Tax Expense | 7,358 | 3,208 |
| Net Income | $11,345 | $6,476 |
| Weighted-Average Shares of Common Stock Outstanding (000) | | |
| Basic | 41,540 | 38,031 |
| Diluted | 41,875 | 38,321 |
| Earnings Per Share | | |
| Basic | $0.27 | $0.17 |
| Diluted | $0.27 | $0.17 |
| Dividends Declared Per Share | $0.435 | $0.43 |

See Notes to Condensed Consolidated Financial Statements.

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UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (Unaudited) | |
| | Thousands of Dollars | |
| Comprehensive Income | | |
| Net Income | $11,345 | $6,476 |
| Other Comprehensive Income | | |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of $(31) and $370 income taxes | 47 | (564) |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of $(370) and $(364) income taxes | 565 | 556 |
| Supplemental Executive Retirement Plan (SERP) Benefit Adjustments, net of $(42) and $19 income taxes | 68 | 108 |
| Total Other Comprehensive Income, Net of Income Taxes | 680 | 100 |
| Total Comprehensive Income | $12,025 | $6,576 |

See Notes to Condensed Consolidated Financial Statements.

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (Unaudited) | |
| | Thousands of Dollars | |
| Cash Flows from Operating Activities | | |
| Cash Receipts from Electric Retail Sales | $253,747 | $240,164 |
| Cash Receipts from Electric Wholesale Sales | 43,538 | 43,034 |
| Cash Receipts from Gas Retail Sales | 59,849 | 62,064 |
| Cash Receipts from Operating Springerville Units 3 & 4 | 25,032 | 25,169 |
| Cash Receipts from Gas Wholesale Sales | 3,152 | 377 |
| Interest Received | 515 | 1,528 |
| Other Cash Receipts | 6,137 | 6,464 |
| Fuel Costs Paid | (76,321) | (76,769) |
| Payment of Operations and Maintenance Costs | (57,173) | (70,967) |
| Purchased Energy Costs Paid | (73,761) | (72,353) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (32,237) | (31,952) |
| Wages Paid, Net of Amounts Capitalized | (36,306) | (38,016) |
| Interest Paid, Net of Amounts Capitalized | (17,784) | (20,490) |
| Capital Lease Interest Paid | (16,123) | (19,369) |
| Other Cash Payments | (1,212) | (2,314) |
| Net Cash Flows—Operating Activities | 81,053 | 46,570 |
| Cash Flows from Investing Activities | | |
| Return of Investments in Springerville Lease Debt | 9,104 | 19,278 |
| Insurance Proceeds for Replacement Assets | — | 2,875 |
| Other Cash Receipts | 2,911 | 4,047 |
| Capital Expenditures | (81,228) | (78,931) |
| Other Cash Payments | (5,304) | (2,223) |
| Net Cash Flows—Investing Activities | (74,517) | (54,954) |
| Cash Flows from Financing Activities | | |
| Proceeds from Borrowings Under Revolving Credit Facilities | 66,000 | 198,000 |
| Other Cash Receipts | 2,690 | 1,463 |
| Repayments of Borrowings Under Revolving Credit Facilities | (35,000) | (92,000) |
| Payments of Capital Lease Obligations | (81,281) | (73,993) |
| Common Stock Dividends Paid | (18,035) | (16,322) |
| Repayments of Long-Term Debt | — | (8,448) |
| Other Cash Payments | (928) | (1,603) |
| Net Cash Flows—Financing Activities | (66,554) | 7,097 |
| Net Decrease in Cash and Cash Equivalents | (60,018) | (1,287) |
| Cash and Cash Equivalents, Beginning of Year | 123,918 | 76,390 |
| Cash and Cash Equivalents, End of Period | $63,900 | $75,103 |

See Note 11 for supplemental cash flow information.
See Notes to Condensed Consolidated Financial Statements.

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| | Thousands of Dollars | |
| ASSETS | | |
| Utility Plant | | |
| Plant in Service | $5,039,638 | $5,005,768 |
| Utility Plant Under Capital Leases | 582,669 | 582,669 |
| Construction Work in Progress | 156,178 | 128,621 |
| Total Utility Plant | 5,778,485 | 5,717,058 |
| Less Accumulated Depreciation and Amortization | (1,943,865) | (1,921,733) |
| Less Accumulated Amortization of Capital Lease Assets | (499,784) | (494,962) |
| Total Utility Plant—Net | 3,334,836 | 3,300,363 |
| Investments and Other Property | | |
| Investments in Lease Equity | 36,302 | 36,339 |
| Other | 37,594 | 36,537 |
| Total Investments and Other Property | 73,896 | 72,876 |
| Current Assets | | |
| Cash and Cash Equivalents | 63,900 | 123,918 |
| Accounts Receivable—Customer | 92,015 | 93,742 |
| Unbilled Accounts Receivable | 39,911 | 53,568 |
| Allowance for Doubtful Accounts | (6,455) | (6,545) |
| Materials and Supplies | 90,790 | 93,322 |
| Fuel Inventory | 62,977 | 62,019 |
| Deferred Income Taxes—Current | 34,705 | 34,260 |
| Regulatory Assets—Current | 45,950 | 51,619 |
| Investments in Lease Debt | — | 9,118 |
| Derivative Instruments | 5,733 | 3,165 |
| Other | 25,450 | 33,567 |
| Total Current Assets | 454,976 | 551,753 |
| Regulatory and Other Assets | | |
| Regulatory Assets—Noncurrent | 188,612 | 191,077 |
| Other Assets | 25,568 | 24,360 |
| Total Regulatory and Other Assets | 214,180 | 215,437 |
| Total Assets | $4,077,888 | $4,140,429 |

See Notes to Condensed Consolidated Financial Statements.

(Continued)

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| | Thousands of Dollars | |
| CAPITALIZATION AND OTHER LIABILITIES | | |
| Capitalization | | |
| Common Stock Equity | $1,059,405 | $1,065,465 |
| Capital Lease Obligations | 179,610 | 262,138 |
| Long-Term Debt | 1,504,473 | 1,498,442 |
| Total Capitalization | 2,743,488 | 2,826,045 |
| Current Liabilities | | |
| Current Obligations Under Capital Leases | 95,587 | 90,583 |
| Borrowings Under Revolving Credit Facilities | 25,000 | — |
| Accounts Payable—Trade | 86,959 | 107,740 |
| Accrued Taxes Other than Income Taxes | 54,473 | 41,939 |
| Interest Accrued | 18,217 | 31,950 |
| Accrued Employee Expenses | 20,247 | 24,094 |
| Regulatory Liabilities—Current | 44,350 | 43,516 |
| Customer Deposits | 34,826 | 34,048 |
| Derivative Instruments | 7,934 | 14,742 |
| Other | 14,836 | 10,517 |
| Total Current Liabilities | 402,429 | 399,129 |
| Deferred Credits and Other Liabilities | | |
| Deferred Income Taxes—Noncurrent | 386,800 | 364,756 |
| Regulatory Liabilities—Noncurrent | 289,197 | 279,111 |
| Pension and Other Retiree Benefits | 161,066 | 159,401 |
| Derivative Instruments | 11,363 | 12,709 |
| Other | 83,545 | 99,278 |
| Total Deferred Credits and Other Liabilities | 931,971 | 915,255 |
| Commitments, Contingencies, and Environmental Matters (Note 6) | | |
| Total Capitalization and Other Liabilities | $4,077,888 | $4,140,429 |

See Notes to Condensed Consolidated Financial Statements.
(Concluded)

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

| | Common Shares Outstanding* | Common Stock | Accumulated Earnings | Accumulated Other Comprehensive Loss | Total Stockholders' Equity |
|---|---|---|---|---|---|
| | Thousands of Shares | (Unaudited) Thousands of Dollars | | | |
| Balances at December 31, 2012 | 41,344 | $882,138 | $193,117 | $ (9,790) | $1,065,465 |
| Comprehensive Income | | | | | |
| 2013 Year-to-Date Net Income | | | 11,345 | | 11,345 |
| Other Comprehensive Income, net of $(443) income taxes | | | | 680 | 680 |
| Total Comprehensive Income | | | | | 12,025 |
| Dividends, Including Non-Cash Dividend Equivalents | | | (18,226) | | (18,226) |
| Shares Issued for Stock Options | 16 | 589 | | | 589 |
| Shares Issued Under Performance Share Awards | 57 | — | | | — |
| Other | | (448) | | | (448) |
| Balances at March 31, 2013 | 41,417 | $882,279 | $186,236 | $ (9,110) | $1,059,405 |

* UNS Energy has 75 million authorized shares of Common Stock.

See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (Unaudited) | |
| | Thousands of Dollars | |
| Operating Revenues | | |
| Electric Retail Sales | $184,881 | $166,331 |
| Electric Wholesale Sales | 34,398 | 29,766 |
| Other Revenues | 28,472 | 27,881 |
| Total Operating Revenues | 247,751 | 223,978 |
| Operating Expenses | | |
| Fuel | 80,798 | 69,974 |
| Purchased Power | 18,928 | 13,626 |
| Transmission | 865 | 963 |
| Increase (Decrease) to Reflect PPFAC Recovery Treatment | (2,360) | (7,686) |
| Total Fuel and Purchased Energy | 98,231 | 76,877 |
| Operations and Maintenance | 77,824 | 82,466 |
| Depreciation | 28,558 | 27,467 |
| Amortization | 9,222 | 9,591 |
| Taxes Other Than Income Taxes | 11,169 | 9,679 |
| Total Operating Expenses | 225,004 | 206,080 |
| Operating Income | 22,747 | 17,898 |
| Other Income (Deductions) | | |
| Interest Income | (4) | 26 |
| Other Income | 2,206 | 2,461 |
| Other Expense | (2,245) | (1,493) |
| Total Other Income (Deductions) | (43) | 994 |
| Interest Expense | | |
| Long-Term Debt | 14,573 | 13,916 |
| Capital Leases | 6,249 | 8,296 |
| Other Interest Expense, Net of Interest Capitalized | (853) | 110 |
| Total Interest Expense | 19,969 | 22,322 |
| Income (Loss) Before Income Taxes | 2,735 | (3,430) |
| Income Tax Expense (Benefit) | 1,257 | (1,969) |
| Net Income (Loss) | $1,478 | $(1,461) |

See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (Unaudited) | |
| | Thousands of Dollars | |
| Comprehensive Income (Loss) | | |
| Net Income (Loss) | $1,478 | $(1,461) |
| Other Comprehensive Income (Loss) | | |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of $(29) and $323 income taxes | 45 | (493) |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of $(350) and $(348) income taxes | 535 | 531 |
| SERP Benefit Adjustments, net of $(42) and $19 income taxes | 68 | 108 |
| Total Other Comprehensive Income, Net of Income Taxes | 648 | 146 |
| Total Comprehensive Income (Loss) | $2,126 | $(1,315) |

See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| | (Unaudited) | |
| | Thousands of Dollars | |
| Cash Flows from Operating Activities | | |
| Cash Receipts from Electric Retail Sales | $211,011 | $194,772 |
| Cash Receipts from Electric Wholesale Sales | 40,061 | 36,069 |
| Cash Receipts from Operating Springerville Units 3 & 4 | 25,032 | 25,169 |
| Cash Receipts from Gas Wholesale Sales | 3,114 | — |
| Reimbursement of Affiliate Charges | 5,883 | 6,988 |
| Interest Received | 509 | 1,523 |
| Other Cash Receipts | 4,624 | 4,719 |
| Fuel Costs Paid | (76,560) | (76,473) |
| Payment of Operations and Maintenance Costs | (54,791) | (70,037) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (23,303) | (22,299) |
| Wages Paid, Net of Amounts Capitalized | (30,542) | (31,728) |
| Purchased Power Costs Paid | (17,417) | (13,019) |
| Interest Paid, Net of Amounts Capitalized | (11,239) | (11,118) |
| Capital Lease Interest Paid | (16,123) | (19,369) |
| Other Cash Payments | (860) | (3,646) |
| Net Cash Flows—Operating Activities | 59,399 | 21,551 |
| Cash Flows from Investing Activities | | |
| Return of Investments in Springerville Lease Debt | 9,104 | 19,278 |
| Insurance Proceeds for Replacement Assets | — | 2,875 |
| Other Cash Receipts | 1,645 | 3,451 |
| Capital Expenditures | (61,668) | (66,845) |
| Other Cash Payments | (4,556) | (1,901) |
| Net Cash Flows—Investing Activities | (55,475) | (43,142) |
| Cash Flows from Financing Activities | | |
| Proceeds from Borrowings Under Revolving Credit Facility | 55,000 | 120,000 |
| Other Cash Receipts | 492 | 377 |
| Repayments of Borrowings Under Revolving Credit Facility | (35,000) | (25,000) |
| Payments of Capital Lease Obligations | (81,281) | (73,993) |
| Repayments of Long-Term Debt | — | (6,535) |
| Other Cash Payments | (874) | (1,504) |
| Net Cash Flows—Financing Activities | (61,663) | 13,345 |
| Net Decrease in Cash and Cash Equivalents | (57,739) | (8,246) |
| Cash and Cash Equivalents, Beginning of Year | 79,743 | 27,718 |
| Cash and Cash Equivalents, End of Period | $22,004 | $19,472 |

See Note 11 for supplemental cash flow information.
See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| | Thousands of Dollars | |
| ASSETS | | |
| Utility Plant | | |
| Plant in Service | $4,371,895 | $4,348,041 |
| Utility Plant Under Capital Leases | 582,669 | 582,669 |
| Construction Work in Progress | 118,020 | 98,460 |
| Total Utility Plant | 5,072,584 | 5,029,170 |
| Less Accumulated Depreciation and Amortization | (1,801,484) | (1,783,787) |
| Less Accumulated Amortization of Capital Lease Assets | (499,784) | (494,962) |
| Total Utility Plant—Net | 2,771,316 | 2,750,421 |
| Investments and Other Property | | |
| Investments in Lease Equity | 36,302 | 36,339 |
| Other | 36,139 | 35,091 |
| Total Investments and Other Property | 72,441 | 71,430 |
| Current Assets | | |
| Cash and Cash Equivalents | 22,004 | 79,743 |
| Accounts Receivable—Customer | 70,717 | 71,813 |
| Unbilled Accounts Receivable | 28,730 | 33,782 |
| Allowance for Doubtful Accounts | (4,494) | (4,598) |
| Accounts Receivable—Due from Affiliates | 6,860 | 5,720 |
| Materials and Supplies | 77,787 | 80,377 |
| Fuel Inventory | 62,673 | 61,737 |
| Deferred Income Taxes—Current | 37,834 | 37,212 |
| Regulatory Assets—Current | 33,148 | 34,345 |
| Investments in Lease Debt | — | 9,118 |
| Other | 26,791 | 34,393 |
| Total Current Assets | 362,050 | 443,642 |
| Regulatory and Other Assets | | |
| Regulatory Assets—Noncurrent | 176,472 | 178,330 |
| Other Assets | 18,219 | 17,223 |
| Total Regulatory and Other Assets | 194,691 | 195,553 |
| Total Assets | $3,400,498 | $3,461,046 |

See Notes to Condensed Consolidated Financial Statements.
(Continued)

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| | Thousands of Dollars | |
| CAPITALIZATION AND OTHER LIABILITIES | | |
| Capitalization | | |
| Common Stock Equity | $863,053 | $860,927 |
| Capital Lease Obligations | 179,610 | 262,138 |
| Long-Term Debt | 1,223,474 | 1,223,442 |
| Total Capitalization | 2,266,137 | 2,346,507 |
| Current Liabilities | | |
| Current Obligations Under Capital Leases | 95,587 | 90,583 |
| Borrowings Under Revolving Credit Facility | 20,000 | — |
| Accounts Payable—Trade | 67,871 | 82,122 |
| Accounts Payable—Due to Affiliates | 2,587 | 3,134 |
| Accrued Taxes Other than Income Taxes | 43,128 | 33,060 |
| Interest Accrued | 16,380 | 26,965 |
| Accrued Employee Expenses | 17,518 | 20,715 |
| Customer Deposits | 25,546 | 24,846 |
| Regulatory Liabilities—Current | 19,958 | 20,822 |
| Derivative Instruments | 3,820 | 4,899 |
| Other | 11,134 | 7,085 |
| Total Current Liabilities | 323,529 | 314,231 |
| Deferred Credits and Other Liabilities | | |
| Deferred Income Taxes—Noncurrent | 331,221 | 319,216 |
| Regulatory Liabilities—Noncurrent | 249,095 | 241,189 |
| Pension and Other Retiree Benefits | 151,006 | 149,718 |
| Derivative Instruments | 10,108 | 10,565 |
| Other | 69,402 | 79,620 |
| Total Deferred Credits and Other Liabilities | 810,832 | 800,308 |
| Commitments, Contingencies, and Environmental Matters (Note 6) | | |
| Total Capitalization and Other Liabilities | $3,400,498 | $3,461,046 |

See Notes to Condensed Consolidated Financial Statements.

(Concluded)

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY

| | Common Stock | Capital Stock Expense | Accumulated Deficit | Accumulated Other Comprehensive Loss | Total Stockholder’s Equity |
|---|---|---|---|---|---|
| | (Unaudited) Thousands of Dollars | | | | |
| Balances at December 31, 2012 | $888,971 | $(6,357) | $(12,157) | $ (9,530) | $860,927 |
| Comprehensive Income | | | | | |
| 2013 Year-to-Date Net Income | | | 1,478 | | 1,478 |
| Other Comprehensive Income, net of $(421) income taxes | | | | 648 | 648 |
| Total Comprehensive Income | | | | | 2,126 |
| Balances at March 31, 2013 | $888,971 | $(6,357) | $(10,679) | $ (8,882) | $863,053 |

See Notes to Condensed Consolidated Financial Statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Unaudited

NOTE 1. FINANCIAL STATEMENT PRESENTATION

UNS Energy Corporation (UNS Energy) is a holding company that conducts its business through three regulated public utilities: Tucson Electric Power Company (TEP); UNS Gas, Inc. (UNS Gas); and UNS Electric, Inc. (UNS Electric). References to “we” and “our” are to UNS Energy and its subsidiaries, collectively.

We prepared our condensed consolidated financial statements according to generally accepted accounting principles in the United States of America (GAAP) and the Securities and Exchange Commission's (SEC) interim reporting requirements. These condensed consolidated financial statements exclude some information and footnotes required by GAAP and the SEC for annual financial statement reporting. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes in UNS Energy's and TEP's Annual Reports on Form 10-K for the year ended December 31, 2012.
The condensed consolidated financial statements are unaudited, but, in management's opinion, include all recurring adjustments necessary for a fair presentation of the results for the interim periods presented. Because weather and other factors cause seasonal fluctuations in sales, our quarterly results are not indicative of annual operating results. UNS Energy and TEP reclassified certain amounts in the financial statements to conform to current year presentation.

REVISION OF PRIOR PERIOD UNS ENERGY INCOME STATEMENT

During the first three quarters of 2012, we incorrectly reported UNS Electric's sales and purchase contracts which did not result in the physical delivery of energy. The transactions were reported on a gross basis rather than on a net basis. This error resulted in a $3 million equal and offsetting overstatement of Electric Wholesale Sales and Purchased Energy in the income statement for the three months ended March 31, 2012. This error had no impact on operating income, net income, retained earnings, or cash flows.

We assessed the impact of this error on prior period financial statements and concluded it was not material to any period. However, this error was significant to individual income statement line items. As a result, in accordance with GAAP, we revised our prior period income statement as follows:

| | UNS Energy<br>Three Months Ended<br>March 31, 2012 | |
|---|---|---|
| | As Reported | As Revised |
| | Thousands of Dollars | |
| Income Statement | | |
| Electric Wholesale Sales | $37,104 | $33,617 |
| Purchased Energy | 63,276 | 59,790 |
| Total Fuel and Purchased Energy | 134,276 | 130,790 |
| Total Operating Expenses | 284,479 | 280,984 |

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RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In the first quarter of 2013, we adopted authoritative guidance that:

- Requires additional disclosures for amounts reclassified out of accumulated other comprehensive income by component. See Note 13.
- Requires disclosure related to offsetting derivative assets and derivative liabilities in accordance with GAAP. See Note 12.
- Allows an additional option for impairment testing of indefinite-lived intangible assets. We had no impairment indicator as our indefinite-lived intangible assets, Renewable Energy Credits (RECs), are currently recoverable under the Renewable Energy Standard (RES) as we use the RECs to comply with the standard's renewable resources requirements.

NOTE 2. REGULATORY MATTERS

RATES AND REGULATION

The Arizona Corporation Commission (ACC) and the Federal Energy Regulatory Commission (FERC) each regulate portions of the utility accounting practices and rates of TEP, UNS Gas, and UNS Electric. The ACC regulates rates charged to retail customers, the siting of generation and transmission facilities, the issuance of securities, and transactions with affiliated parties. The FERC regulates terms and prices of transmission services and wholesale electricity sales.

PENDING TEP RATE CASE

In July 2012, TEP filed a general rate case, on a cost-of-service basis, with the ACC requesting a Base Rate increase of approximately 15% to cover a revenue deficiency of $128 million. TEP requested a 7.74% return on Original Cost Rate Base (OCRB) of $1.5 billion  and a 5.68% return on Fair Value Rate Base (FVRB) of $2.3 billion   TEP also requested a 1.56% return on the fair value increment of rate base. The fair value increment of rate base represents the difference between OCRB and FVRB of approximately $800 million.

TEP requested a Lost Fixed Cost Recovery (LFCR) mechanism to recover non-fuel costs that would go unrecovered due to lost kilowatt-hour (kWh) sales as a result of implementing the ACC's Electric Energy Efficiency Standards (Electric EE Standards) and the RES. TEP also requested a mechanism, which would be adjusted annually, to recover the costs of complying with environmental standards required by federal or other governmental agencies between rate cases.

TEP proposed a three-year pilot program allowing for investment in programs to meet the Electric EE Standards in the most cost effective manner. Under TEP's proposal, energy efficiency investments would be considered regulatory assets and amortized over a four-year period. TEP would earn a return on investment and recover the return and amortization expense through the existing DSM surcharge.

In February 2013, TEP, ACC Staff, and other parties to TEP's pending rate case proceeding entered into a proposed settlement agreement. The proposed settlement agreement requires the approval of the ACC before new rates can become effective. In the proposed settlement, TEP requested that the Purchased Power and Fuel Adjustment Clause (PPFAC) rate currently approved at 0.77 cents per kWh effective April 2012 be reset at the time new rates become effective.

In March 2013, hearings before an ACC Administrative Law Judge (ALJ) concluded. The ALJ will prepare a recommended opinion and order, which must be approved by the ACC before new rates may become effective.

PENDING UNS ELECTRIC RATE CASE

In December 2012, as required in the 2010 UNS Electric Rate Order, UNS Electric filed with the ACC a general rate case, on a cost-of-service basis, requesting a non-fuel Base Rate increase of $7.5 million, or 4.6%. UNS Electric requested a rate of return of 8.4% on an OCRB of approximately $217 million and a 6.7% rate of return on a FVRB of $286 million. UNS Electric also requested a 1.6% return on the fair value increment of rate base. The fair value increment of rate base represents the difference between OCRB and FVRB of approximately $69 million.

UNS Electric requested a LFCR mechanism to recover non-fuel costs that would go unrecovered due to lost kWh sales as a result of implementing Electric EE Standards and the RES. In addition to the LFCR mechanism, UNS Electric requested a

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

Transmission Cost Adjustor (TCA). The TCA is designed to track changes to UNS Electric's FERC-approved Open Access Transmission Tariff (OATT) rate which is updated annually and would allow UNS Electric to recover transmission costs in a timely manner.

REGULATORY ASSETS AND LIABILITIES

The following table summarizes significant changes in regulatory assets and liabilities since December 31, 2012:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | UNS Energy | TEP | UNS Energy | TEP |
| | Millions of Dollars | | | |
| Regulatory Assets – Current[1] | $46 | $33 | 52 | $34 |
| Regulatory Assets – Noncurrent | 189 | 176 | 191 | 178 |
| Regulatory Liabilities—Current | (44) | (20) | (44) | (21) |
| Regulatory Liabilities – Noncurrent[2] | (289) | (249) | (279) | (241) |
| Total Net Regulatory Assets (Liabilities) | $(98) | $(60) | $(80) | $(50) |

(1) Regulatory Assets – Current on the balance sheet is lower due to a reduction in unrealized losses on energy contracts that are recoverable through the PPFAC/PGA when settled.

(2) Regulatory Liabilities – Noncurrent on the balance sheet is higher due to the increase in the reserve for the net cost of removal related to interim and future retirements at TEP.

FUTURE IMPLICATIONS OF DISCONTINUING APPLICATION OF REGULATORY ACCOUNTING

We regularly assess whether we can continue to apply regulatory accounting to regulated operations, and we have concluded regulatory accounting is applicable. If we stopped applying regulatory accounting to our regulated operations, the following would occur:

- Regulatory pension assets would be reflected in Accumulated Other Comprehensive Income (AOCI);
- We would write off remaining regulatory assets as an expense and regulatory liabilities as income in the income statements;
- At March 31, 2013, based on regulatory assets balances, net of regulatory liabilities:
- TEP would have recorded an extraordinary after-tax gain of $113 million and an after-tax loss in AOCI of $77 million;
- UNS Gas would have recorded an extraordinary after-tax gain of $25 million and an after-tax loss in AOCI of $2 million; and
- UNS Electric would have recorded an extraordinary after-tax gain of $4 million and an after-tax loss in AOCI of $3 million.

While future regulatory orders and market conditions may affect cash flows, our cash flows would not be affected if we stopped applying regulatory accounting to our regulated operations.

NOTE 3. BUSINESS SEGMENTS

We have three reportable segments regularly reviewed by our chief operating decision makers to evaluate performance and make operating decisions.

(1) TEP, a regulated electric utility, is our largest subsidiary;
(2) UNS Gas, a regulated gas distribution utility; and
(3) UNS Electric, a regulated electric utility.

Other includes UNS Energy and UniSource Energy Services holding companies, Millennium, and UniSource Energy Development.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

We disclose selected financial data for our reportable segments in the following table:

| | Reportable Segments | | | | | |
|---|---|---|---|---|---|---|
| | TEP | UNS Gas | UNS Electric | Other | Reconciling Adjustments | UNS Energy Consolidated |
| | Millions of Dollars | | | | | |
| Income Statement | | | | | | |
| Three Months Ended March 31, 2013: | | | | | | |
| Operating Revenues – External | $244 | $52 | $36 | $— | $— | $ 332 |
| Operating Revenues – Intersegment[(1)] | 4 | — | 1 | 4 | (9) | — |
| Income Before Income Taxes | 3 | 12 | 4 | — | — | 19 |
| Net Income | 1 | 8 | 2 | — | — | 11 |
| Three Months Ended March 31, 2012: | | | | | | |
| Operating Revenues – External | $220 | $52 | $44 | $(1) | $— | $ 315 |
| Operating Revenues – Intersegment[(1)] | 4 | 1 | — | 4 | (9) | — |
| Income (Loss) Before Income Taxes | (3) | 9 | 5 | (1) | — | 10 |
| Net Income (Loss) | (1) | 5 | 3 | (1) | — | 6 |

(1) Operating Revenues – Intersegment: TEP includes control area services provided to UNS Electric based on a FERC-approved tariff; common costs (systems, facilities, etc.) allocated to affiliates on a cost-causative basis; and sales of power to UNS Electric at third-party market prices. Other primarily includes meter reading services and supplemental workforce provided by an unregulated affiliate to the utilities.

NOTE 4. DEBT

We summarize below the significant changes to our debt from those reported in our 2012 Annual Report on Form 10-K.

TEP TAX-EXEMPT BONDS ISSUED

In March 2013, the Industrial Development Authority of Pima County, Arizona issued approximately $91 million of unsecured tax-exempt industrial development bonds on behalf of TEP. The bonds bear interest at a fixed rate of 4.0%, mature in September 2029, and may be redeemed at par on or after March 1, 2023. The proceeds from the sale of the bonds, together with $0.5 million accrued interest provided by TEP, were deposited with a trustee to retire approximately $91 million of 6.375%  unsecured tax-exempt bonds in April 2013. TEP’s payment of accrued interest was the only cash flow activity since proceeds from the newly-issued bonds were not received nor disbursed by TEP. TEP capitalized approximately $1 million in costs related to the issuance of the bonds and will amortize the costs to Interest Expense – Long-Term Debt in the income statement through September 2029, the term of the bonds. The new bonds are reflected in Long-Term Debt on the balance sheet and the old bonds have been defeased.

COVENANT COMPLIANCE

At March 31, 2013, we were in compliance with the terms of our loan and credit agreements.

NOTE 5. INCOME TAXES

Income tax expense differs from the amount of income tax determined by applying the United States statutory federal income tax rate of 35% to pre-tax income due to the following:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Three Months Ended March 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Federal Income Tax Expense (Benefit) at Statutory Rate | $7 | $3 | $1 | $(1) |
| State Income Tax Expense, Net of Federal Deduction | 1 | 1 | — | — |
| Cash Surrender Value of Life Insurance | — | (1) | — | (1) |
| Other | (1) | — | — | — |
| Total Federal and State Income Tax Expense (Benefit) | $7 | $3 | $1 | $(2) |

Uncertain Tax Positions

We recognize tax benefits from uncertain tax positions if it is more likely than not that the tax position will be sustained on examination by the taxing authorities. Each uncertain tax position is recognized up to the amount most likely to be sustained on examination and adjusted with changes in facts and circumstances. A reconciliation of the beginning and ending balances of unrecognized tax benefits follows:

| | UNS Energy | TEP |
|---|---|---|
| | Millions of Dollars | |
| Unrecognized Tax Benefits at December 31, 2012 | $30 | $23 |
| Reduction of Positions from Prior Year Based on Tax Authority Ruling | (28) | (22) |
| Unrecognized Tax Benefits at March 31, 2013 | $2 | $1 |

In February 2013, we received a favorable ruling from the Internal Revenue Service (IRS) allowing us to deduct up-front incentive payments to customers who install renewable energy resources. These customers transfer environmental attributes or RECs associated with their renewable installations to us over the expected life of the contract for an up-front incentive payment based on the generating capacity of their installation. As a result of this ruling, in the first quarter, UNS Energy reduced unrecognized tax benefits by $28 million, and TEP reduced unrecognized tax benefits by $22 million. The changes in tax benefits primarily affected the balance sheets.

The IRS completed its audit of the 2009 and 2010 tax returns in March 2013 with no change to the financial statements.

In April 2013, the IRS provided notice of intent to audit the 2011 tax returns.

NOTE 6. COMMITMENTS, CONTINGENCIES, AND ENVIRONMENTAL MATTERS

In addition to those reported in our 2012 Annual Report on Form 10-K, we entered into the following new long-term commitments.

TEP COMMITMENTS

Purchase Power Contracts

TEP entered into new forward purchase power commitments that will settle through December 2014. Some of these contracts are at fixed prices per MWh and others are indexed to natural gas prices. Based on projected market prices as of March 31, 2013, TEP's estimated minimum payment obligations for these purchases are $2 million in 2014.

RES Recoverable Incentives
RES allows for utilities to make various incentive payments to customers who install distributed generation. The two types of incentives are up-front incentive payments and Performance-based Incentives (PBIs). Up-front incentive payments are distinguished by the following:
- Residential and small commercial customers;
- Small installations; and
- Up-front payment upon installation.

PBIs are distinguished by the following:
- Large commercial customers;
- Large installations; and
- Payment over the term of the contract.

RES Performance-based Incentives
TEP entered into new purchase agreements to purchase the environmental attributes, or RECs, from retail customers with solar installations. Payments for these RECs are termed PBIs and are paid in contractually agreed-upon intervals, usually quarterly, based on metered renewable energy production over periods ranging from 9 to 20 years. TEP's total obligation related to RES PBI payments over future periods increased by $4 million dollars from $62 million on December 31, 2012, to $66 million on March 31, 2013. PBIs are recoverable through the RES tariff.
UNS GAS COMMITMENTS
UNS Gas entered into new forward energy commitments that settle through December 2015 at fixed prices per million British thermal units (MMBtu). UNS Gas' minimum payment obligations for these purchases are $1 million in 2014 and $2 million in 2015.

UNS ELECTRIC COMMITMENTS
Purchase Power Contracts
UNS Electric entered into new forward purchase power commitments that will settle through December 2014 at fixed prices per MWh. UNS Electric's minimum payment obligations for these purchases are $1 million in 2014.

RES Performance-Based Incentives

UNS Electric is contractually obligated to retail customers with solar installations to make RES PBI payments for environmental attributes, or RECs. In 2013, UNS Electric's total obligation for RES PBIs increased by approximately $1 million from $6 million on December 31, 2012, to $7 million on March 31, 2013. UNS Electric will make payments over periods ranging from 10 to 20 years based on metered renewable energy production. PBIs are recoverable through the RES tariff.
TEP CONTINGENCIES
Claim Related to San Juan Generating Station
San Juan Coal Company (SJCC) operates an underground coal mine in an area where certain gas producers have oil and gas leases with the federal government, the State of New Mexico, and private parties. These gas producers allege that SJCC's underground coal mine interferes with their operations, reducing the amount of natural gas they can recover. SJCC compensated certain gas producers for any remaining production from wells deemed close enough to the mine to warrant plugging and abandoning them. These settlements, however, do not resolve all potential claims by gas producers in the area. TEP owns 50% of Units 1 and 2 at San Juan Generating Station (San Juan), which represents approximately 20% of the total generation capacity at San Juan, and is responsible for its share of any settlements. TEP cannot estimate the impact of any future claims by these gas producers on the cost of coal at San Juan.
Claims Related to Four Corners Generating Station

In October 2011, EarthJustice, on behalf of several environmental organizations, filed a lawsuit in the United States District Court for the District of New Mexico against Arizona Public Service Company (APS) and the other Four Corners Generating

Station (Four Corners) participants alleging violations of the Prevention of Significant Deterioration (PSD) provisions of the Clean Air Act at Four Corners. In January 2012, EarthJustice amended their complaint alleging violations of New Source Performance Standards resulting from equipment replacements at Four Corners. Among other things, the plaintiffs seek to have the court issue an order to cease operations at Four Corners until any required PSD permits are issued and order the payment of civil penalties, including a beneficial mitigation project. In April 2012, APS filed Motions to Dismiss with the Court for all claims asserted by EarthJustice in the amended complaint.

TEP owns 7% of Four Corners Units 4 and 5 and is liable for its share of any resulting liabilities. TEP cannot predict the final outcome of the claims relating to Four Corners, and, due to the general and non-specific nature of the claims and the indeterminate scope and nature of the injunctive relief sought for this claim, TEP cannot determine estimates of the range of loss at this time. TEP accrued estimated losses of less than $1 million in 2011 for this claim based on its share of a settlement offer to resolve the claim.

Mine Closure Reclamation at Generating Stations Not Operated by TEP

TEP pays ongoing reclamation costs related to coal mines that supply generating stations in which TEP has an ownership interest but does not operate. TEP is liable for a portion of final reclamation costs upon closure of the mines servicing Navajo Generating Station (Navajo), San Juan, and Four Corners. TEP’s share of reclamation costs is expected to be $27 million upon expiration of the coal supply agreements, which expire between 2016 and 2019. The reclamation liability (present value of future liability) recorded at March 31, 2013 and December 31, 2012, was $16 million.

Amounts recorded for final reclamation are subject to various assumptions, such as estimations of reclamation costs, the dates when final reclamation will occur, and the credit-adjusted risk-free interest rate to be used to discount future liabilities. As these assumptions change, TEP will prospectively adjust the expense amounts for final reclamation over the remaining coal supply agreements’ terms. TEP does not believe that recognition of its final reclamation obligations will be material to TEP in any single year because recognition will occur over the remaining terms of its coal supply agreements.

TEP’s PPFAC allows us to pass through most fuel costs, including final reclamation costs, to customers. Therefore, TEP classifies these costs as a regulatory asset by increasing the regulatory asset and the reclamation liability over the remaining life of the coal supply agreements on an accrual basis and recovering the regulatory asset through the PPFAC as final mine reclamation costs are paid to the coal suppliers.

Tucson to Nogales Transmission Line

TEP and UNS Electric are parties to a project development agreement for the joint construction of a 60-mile transmission line from Tucson, Arizona to Nogales, Arizona. This project was initiated in response to an order by the ACC to UNS Electric to improve the reliability of electric service in Nogales. TEP and UNS Electric expect to abandon the project based on the cost of the proposed 345-kV line, the difficulty in reaching agreement with the Forest Service on a path for the line, and concurrence by the ACC of recent transmission plans filed by TEP and UNS Electric supporting elimination of this project. In TEP's pending rate case proceedings before the ACC, TEP entered into a proposed settlement agreement in which it agrees to seek recovery of the project costs from FERC before seeking rate recovery from the ACC. In 2012, TEP recorded a regulatory asset of $5 million and UNS Electric recorded a regulatory asset of $0.2 million for the balance deemed probable of recovery.

Springerville Unit 1 Leases

The Springerville Unit 1 Leases have an initial term to January 2015 and provide for renewal periods of three or more years through 2030. TEP has a fair market value purchase option for facilities under the Springerville Unit 1 Leases. In December 2011, TEP and the owner participants of the Springerville Unit 1 Leases completed a formal appraisal process to determine the fair market value purchase price, in accordance with the Springerville Unit 1 Leases. Based on that appraisal, TEP would have to pay $159 million in 2015 for the 86% interest not already owned by TEP. In 2012, TEP initiated a proceeding seeking judicial confirmation of the results of the appraisal process in Federal District Court. In the proceeding, the owner participants alleged that the appraisal process failed to yield a legitimate purchase price for the leased interest. In January 2013, the Federal District Court denied TEP's petition on the grounds that the court lacks jurisdiction in the matter. In February 2013, TEP appealed the matter to the U.S. Court of Appeals for the Ninth Circuit, where it is currently pending.

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Resolution of Contingencies

Springerville Generating Station Unit 3 Outage

TEP paid Tri-State Generating and Transmission Association, Inc. (Tri-State) $2 million in March 2013 as a result of an outage at Springerville Unit 3 in 2012. TEP accrued the pre-tax loss in July 2012 as a result of not meeting certain availability requirements under the terms of TEP's operating agreement with Tri-State.

ENVIRONMENTAL MATTERS

Environmental Regulation

The Environmental Protection Agency (EPA) limits the amount of sulfur dioxide ($SO_2$), nitrogen oxide (NOx), particulate matter, mercury and other emissions released into the atmosphere by power plants. TEP may incur added costs to comply with future changes in federal and state environmental laws, regulations, and permit requirements at its power plants. Complying with these changes may reduce operating efficiency. TEP expects to recover the cost of environmental compliance from its ratepayers.

Hazardous Air Pollutant Requirements

The Clean Air Act requires the EPA to develop emission limit standards for hazardous air pollutants that reflect the maximum achievable control technology. In February 2012, the EPA issued final rules to set the standards for the control of mercury emissions and other hazardous air pollutants from power plants.

Navajo

Based on the EPA’s final standards, Navajo may need mercury and particulate matter emission control equipment by 2015. TEP’s share of the estimated capital cost of this equipment is less than $1 million for mercury control and about $43 million if the installation of baghouses to control particulates is necessary. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than $1 million each. The operator of Navajo is currently analyzing the need for baghouses under various regulatory scenarios, which will be affected by final Best Available Retrofit Technology (BART) rules when issued.

San Juan

TEP expects San Juan’s current emission controls to be adequate to comply with the EPA’s final standards.

Four Corners

Based on the EPA’s final standards, Four Corners may need mercury emission control equipment by 2015. The estimated capital cost of this equipment is less than $1 million. TEP expects its share of the annual operating cost of the mercury emission control equipment to be less than $1 million.

Springerville Generating Station

Based on the EPA’s final standards, Springerville Generating Station (Springerville) may need mercury emission control equipment by 2015. The estimated capital cost of this equipment for Springerville Units 1 and 2 is about $5 million. TEP expects the annual operating cost of the mercury emission control equipment to be about $3 million.

Sundt Generating Station

TEP expects the final EPA standards will have little effect on capital expenditures at Sundt Generating Station (Sundt).

Regional Haze Rules

The EPA's Regional Haze Rules require emission controls known as BART for certain industrial facilities emitting air pollutants that reduce visibility. The rules call for all states to establish goals and emission reduction strategies for improving visibility in national parks and wilderness areas. States must submit these goals and strategies to the EPA for approval. Because Navajo and Four Corners are located on the Navajo Indian Reservation, they are not subject to state oversight. The EPA oversees regional haze planning for these power plants.

Complying with the EPA’s BART findings, and with other future environmental rules, may make it economically impractical to continue operating the Navajo, San Juan, and Four Corners power plants or for individual owners to continue to participate in these power plants. TEP cannot predict the ultimate outcome of these matters.

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Navajo

In January 2013, the EPA proposed an alternative BART determination that would require the installation of Selective Catalytic Reduction (SCR) technology on all three units at Navajo by 2023. If SCR technology is ultimately required at Navajo, TEP estimates its share of the capital cost will be $42 million. Also, the installation of SCR technology at Navajo could increase the power plant's particulate emissions which may require that baghouses be installed. TEP estimates that its share of the capital expenditure for baghouses would be about $43 million. TEP's share of annual operating costs for SCR and baghouses is estimated at less than $1 million each.

San Juan

In August 2011, the EPA issued a Federal Implementation Plan (FIP) establishing new emission limits for air pollutants at San Juan. These requirements are more stringent than those proposed by the State of New Mexico. The FIP requires the installation of SCR technology with sorbent injection on all four units to reduce NOx and control sulfuric acid emissions by September 2016. TEP estimates its share of the cost to install SCR technology with sorbent injection to be between $180 million and $200 million. TEP expects its share of the annual operating costs for SCR technology to be approximately $6 million.

In 2011, Public Service Company of New Mexico (PNM) filed a petition for review of, and a motion to stay, the FIP with the Tenth Circuit United States Court of Appeals (Tenth Circuit). In addition, PNM filed a request for reconsideration of the rule with the EPA and a request to stay the effectiveness of the rule pending the EPA's reconsideration and review by the Tenth Circuit. The State of New Mexico filed similar motions with the Tenth Circuit and the EPA. Several environmental groups were granted permission to join in opposition to PNM's petition to review in the Tenth Circuit. In addition, WildEarth Guardians filed a separate appeal against the EPA challenging the FIP's five-year implementation schedule. PNM was granted permission to join in opposition to that appeal. In March 2012, the Tenth Circuit denied PNM's and the State of New Mexico's motion for stay. Oral argument on the appeal was heard in October 2012 and the parties are currently awaiting the court's decision. In February 2013, the Tenth Circuit referred the litigation to the Tenth Circuit Mediation Office, which has authority to require the parties to attend mediation conferences to informally resolve issues in the pending appeals.

In February 2013, the State of New Mexico, the EPA, and PNM signed a non-binding agreement that outlines an alternative to the FIP. The terms of the agreement include: the retirement of San Juan Units 2 and 3 by December 31, 2017; the replacement of those units with non-coal generation sources; and the installation of selective non-catalytic reduction technology (SNCR) on San Juan Units 1 and 4 by January 2016 or later depending on the timing of EPA approvals. TEP estimates its share of the cost to install SNCR technology on San Juan Unit 1 would be approximately $25 million. TEP owns 340 MW, or 50%, of San Juan Units 1 and 2. At March 31, 2013, the book value of TEP's share of San Juan Units 1 and 2 was $215 million. If Unit 2 is retired early, we expect to request ACC approval to recover, over a reasonable time period, all costs associated with the early closure of the unit. We are evaluating various replacement resources. Any decision regarding early closure and replacement resources will require various actions by third parties as well as UNS Energy board and regulatory approvals. TEP cannot predict the ultimate outcome of this matter.

Four Corners

In August 2012, the EPA finalized the regional haze FIP for Four Corners. The final FIP requires SCR technology to be installed on all five units by 2017. However, the FIP also includes an alternative plan that allows APS to close their wholly-owned Units 1, 2, and 3 and install SCR technology on Units 4 and 5. This option allows the installation of SCR technology to be delayed until July 2018. In either case, TEP's estimated share of the capital costs to install SCR technology on Units 4 and 5 is about $35 million. TEP's share of incremental annual operating costs for SCR is estimated at $2 million.

Springerville

Provisions of the Regional Haze Rules requiring emission control upgrades do not apply to Springerville currently and are not likely to impact Springerville operations until after 2018.

Sundt

In December 2012, the EPA issued a proposed rule on provisions that had not been previously addressed in the Arizona State Implementation Plan related to regional haze. The EPA disagreed with the determination that Sundt Unit 4 is not subject to the BART provisions of the Regional Haze Rule. If the BART eligibility determination stands, Sundt Unit 4 will be required to reduce certain emissions within five years of the final EPA BART determination. The EPA postponed its expected release of a proposed BART requirement for Sundt Unit 4 until September 6, 2013, with a final determination expected in February 2014.

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## NOTE 7. EMPLOYEE BENEFIT PLANS

UNS Energy's net periodic benefit plan cost, comprised primarily of TEP's cost, includes the following components:

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | Three Months Ended March 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Service Cost | $3 | $2 | $1 | $— |
| Interest Cost | 4 | 4 | 1 | 1 |
| Expected Return on Plan Assets | (5) | (4) | — | — |
| Actuarial Loss Amortization | 2 | 2 | — | — |
| Net Periodic Benefit Cost | $4 | $4 | $2 | $1 |

## NOTE 8. SHARE-BASED COMPENSATION PLANS

### RESTRICTED STOCK UNITS AND PERFORMANCE SHARES

Restricted Stock Units

In February 2013, the UNS Energy Compensation Committee granted 21,560 restricted stock units to certain management employees at a grant date fair value of $46.23 per share. The restricted stock units vest on the third anniversary of grant and are distributed in shares of UNS Energy's Common Stock (Common Stock) upon vesting. We recognize compensation expense equal to the fair market value on the grant date over the vesting period. Restricted stock units accrue dividend equivalents, during the vesting period, which are distributed in shares of Common Stock upon vesting.

Performance Shares

In February 2013, the UNS Energy Compensation Committee granted 43,120 performance share awards to certain management employees. Half of the performance share awards had a grant date fair value, based on a Monte Carlo simulation, of $45.54 per share. Those awards will be paid out in Common Stock based on a comparison of UNS Energy's cumulative Total Shareholder Return to the Edison Electric Institute Index during the performance period of January 1, 2013 through December 31, 2015. The remaining half had a grant date fair value of $46.23 per share and will be paid out in Common Stock based on cumulative net income for the three-year period ended December 31, 2015. The performance shares vest based on the achievement of these goals by the end of the performance period; any unearned awards are forfeited. Performance shares accrue dividend equivalents, during the performance period, which are paid upon vesting.

### SHARE-BASED COMPENSATION EXPENSE

UNS Energy and TEP recorded less than $1 million of share-based compensation expense for the three months ended March 31, 2013 and March 31, 2012.

At March 31, 2013, the total unrecognized compensation cost related to non-vested share-based compensation was $5 million, which will be recorded as compensation expense over the remaining vesting periods through February 2016. At March 31, 2013, 1 million shares were awarded but not yet issued, including target performance based shares, under the share-based compensation plans.

## NOTE 9. FAIR VALUE MEASUREMENTS

We categorize our assets and liabilities accounted for at fair value into the three-level hierarchy based on inputs used to determine the fair value. Level 1 inputs are unadjusted quoted prices for identical assets or liabilities in an active market. Level 2 inputs include quoted prices for similar assets or liabilities, quoted prices in non-active markets, and pricing models whose inputs are observable. Level 3 inputs are unobservable and supported by little or no market activity.

The following tables present, by level within the fair value hierarchy, UNS Energy's and TEP's assets and liabilities accounted for at fair value on a recurring basis. These assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. There were no transfers between Levels 1, 2, or 3 for either reporting period.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

| | UNS Energy Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | March 31, 2013 Millions of Dollars | | | |
| Assets | | | | |
| Cash Equivalents(1) | $15 | $— | $— | $15 |
| Restricted Cash Equivalents(1) | 7 | — | — | 7 |
| Rabbi Trust Investments to Support the Deferred Compensation and Supplemental Executive Retirement Plan (SERP)(2) | — | 20 | — | 20 |
| Energy Contracts(3) | — | 5 | 4 | 9 |
| Total Assets | 22 | 25 | 4 | 51 |
| Liabilities | | | | |
| Energy Contracts(3) | — | (3) | (7) | (10) |
| Interest Rate Swaps(4) | — | (9) | — | (9) |
| Total Liabilities | — | (12) | (7) | (19) |
| Net Total Assets (Liabilities) | $22 | $13 | $(3) | $32 |

| | UNS Energy Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | December 31, 2012 Millions of Dollars | | | |
| Assets | | | | |
| Cash Equivalents(1) | $20 | $— | $— | $20 |
| Restricted Cash Equivalents(1) | 7 | — | — | 7 |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP(2) | — | 19 | — | 19 |
| Energy Contracts(3) | — | 2 | 5 | 7 |
| Total Assets | 27 | 21 | 5 | 53 |
| Liabilities | | | | |
| Energy Contracts(3) | — | (7) | (10) | (17) |
| Interest Rate Swaps(4) | — | (10) | — | (10) |
| Total Liabilities | — | (17) | (10) | (27) |
| Net Total Assets (Liabilities) | $27 | $4 | $(5) | $26 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

| | TEP Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | March 31, 2013 Millions of Dollars | | | |
| Assets | | | | |
| Restricted Cash Equivalents[1] | $7 | $— | $— | $7 |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP[2] | — | 20 | — | 20 |
| Energy Contracts[3] | — | 2 | 3 | 5 |
| Total Assets | 7 | 22 | 3 | 32 |
| Liabilities | | | | |
| Energy Contracts[3] | — | (1) | (4) | (5) |
| Interest Rate Swaps[4] | — | (9) | — | (9) |
| Total Liabilities | — | (10) | (4) | (14) |
| Net Total Assets (Liabilities) | $7 | $12 | $(1) | $18 |

| | TEP Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | December 31, 2012 Millions of Dollars | | | |
| Assets | | | | |
| Cash Equivalents[1] | $1 | $— | $— | $1 |
| Restricted Cash Equivalents[1] | 7 | — | — | 7 |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP[2] | — | 19 | — | 19 |
| Energy Contracts[3] | — | 1 | 2 | 3 |
| Total Assets | 8 | 20 | 2 | 30 |
| Liabilities | | | | |
| Energy Contracts[3] | — | (3) | (2) | (5) |
| Interest Rate Swaps[4] | — | (10) | — | (10) |
| Total Liabilities | — | (13) | (2) | (15) |
| Net Total Assets (Liabilities) | $8 | $7 | $— | $15 |

(1) Cash Equivalents and Restricted Cash Equivalents represent amounts held in money market funds and certificates of deposit valued at cost, including interest. Cash Equivalents are included in Cash and Cash Equivalents on the balance sheets. Restricted Cash Equivalents is included in Investments and Other Property—Other on the balance sheets.

(2) Rabbi Trust Investments include amounts related to deferred compensation and SERP benefits held in mutual and money market funds valued at quoted prices traded in active markets. These investments are included in Investments and Other Property – Other on the balance sheets.

(3) Energy Contracts include gas swap agreements (Level 2), gas and power options (Level 3), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to reduce exposure to energy price risk. These contracts are included in Derivative Instruments and Other Assets on the balance sheets. The valuation techniques are described below. See Note 12.

(4) Interest Rate Swaps are valued based on the 3-month or 6-month London Interbank Offered Rate index or the Securities Industry and Financial Markets Association municipal swap index. These interest rate swaps are included in Derivative Instruments on the balance sheets.

ENERGY CONTRACTS

We primarily apply the market approach for recurring fair value measurements. When we have observable inputs for substantially the full term of the asset or liability, such as gas swap derivatives valued using New York Mercantile Exchange pricing, adjusted for basis differences, we categorize the instrument in Level 2. We categorize derivatives in Level 3 when we use an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers.

For both power and gas prices we obtain quotes from brokers, major market participants, exchanges, or industry publications and rely on our own price experience from active transactions in the market. We primarily use one set of quotations each for power and for gas and then validate those prices using other sources. We believe that the market information provided is reflective of market conditions as of the time and date indicated.

Published prices for energy derivative contracts may not be available due to the nature of contract delivery terms such as non-standard time blocks and non-standard delivery points. In these cases, we apply adjustments based on historical price curve relationships, transmission, and line losses.

We estimate the fair value of our options using a Black-Scholes-Merton option pricing model which includes inputs such as implied volatility, correlations, interest rates, and forward price curves.

We also consider the impact of counterparty credit risk using current and historical default and recovery rates, as well as our own credit risk using credit default swap data.

Our assessments of the significance of a particular input to the fair value measurements require judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. We review the assumptions underlying our contracts monthly.

The following table provides quantitative information regarding significant unobservable inputs in UNS Energy's Level 3 fair value measurements:

| | Fair Value at March 31, 2013 | | Range of |
|---|---|---|---|
| | Assets | Liabilities | Unobservable Input |
| | Millions of Dollars | | |
| Forward Contracts[1] | $2 | $(7) | |
| Valuation Technique: Market approach | | | |
| Unobservable Input: | | | |
| Market price per MWh | | | $26.00 - $58.91 |
| Option Contracts[2] | 2 | — | |
| Valuation Technique: Option model | | | |
| Unobservable Inputs: | | | |
| Market Price per MWh | | | $36.50 - $49.50 |
| Power Volatility | | | 29.3% - 53.6% |
| Market Price per MMbtu | | | $3.82 - $4.23 |
| Gas Volatility | | | 27.2% - 28.9% |
| Level 3 Energy Contracts | $4 | $(7) | |

(1) TEP comprises $1 million of the forward contract assets and $(4) million of the forward contract liabilities.
(2) All of the option contracts relate to TEP.

Our exposure to risk resulting from changes in the unobservable inputs identified above is mitigated as we report the change in fair value of energy contract derivatives as a regulatory asset or a regulatory liability recoverable through the PPFAC or PGA mechanisms, or as a component of other comprehensive income, rather than in the income statement.

The following tables present a reconciliation of changes in the fair value of assets and liabilities classified as Level 3 in the fair value hierarchy:

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| | Three Months Ended March 31, 2013 | |
|---|---|---|
| | UNS Energy | TEP |
| | Millions of Dollars | |
| Balances as of December 31, 2012 | $(5) | $— |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities – Derivative Instruments | 1 | (1) |
| Settlements | 1 | — |
| Balances as of March 31, 2013 | $(3) | $(1) |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | $1 | $(1) |

| | Three Months Ended March 31, 2012 | |
|---|---|---|
| | UNS Energy | TEP |
| | Millions of Dollars | |
| Balances as of December 31, 2011 | $(10) | $— |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities – Derivative Instruments | (5) | 1 |
| Other Comprehensive Loss | (1) | (1) |
| Settlements | 3 | — |
| Balances as of March 31, 2012 | $(13) | $— |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | $(2) | $— |

FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

The fair value of a financial instrument is the market price to sell an asset or transfer a liability at the measurement date. We use the following methods and assumptions for estimating the fair value of our financial instruments:

- The carrying amounts of our current assets, current liabilities, including current maturities of long-term debt, and amounts outstanding under our credit agreements approximate the fair values due to the short-term nature of these financial instruments. These items have been excluded from the table below.

- For Investment in Lease Debt, we calculate the present value of remaining cash flows using current market rates for instruments with similar characteristics such as credit rating and time-to-maturity. We also incorporate the impact of counterparty credit risk using market credit default swap data.

- For Investment in Lease Equity, we estimate the price at which an investor would realize a target internal rate of return. Our estimates include: the mix of debt and equity an investor would use to finance the purchase; the cost of debt; the required return on equity; and income tax rates. The estimate assumes a residual value based on an appraisal of Springerville Unit 1 in 2011.

- For Long-Term Debt, we use quoted market prices, when available, or calculate the present value of remaining cash flows at the balance sheet date. When calculating present value, we use current market rates for bonds with similar characteristics such as credit rating and time-to-maturity. We consider the principal amounts of variable rate debt outstanding to be reasonable estimates of the fair value. We also incorporate the impact of our own credit risk using a credit default swap rate.

The use of different estimation methods and/or market assumptions may yield different estimated fair value amounts. The carrying values recorded on the balance sheets and the estimated fair values of our financial instruments include the following:

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| | | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|---|
| | Fair Value Hierarchy | Carrying Value | Fair Value | Carrying Value | Fair Value |
| | | Millions of Dollars | | | |
| Assets: | | | | | |
| TEP Investment in Lease Debt | Level 2 | $— | $— | $9 | $9 |
| TEP Investment in Lease Equity | Level 3 | 36 | 23 | 36 | 23 |
| Liabilities: | | | | | |
| Long-Term Debt | | | | | |
| UNS Energy | Level 2 | 1,504 | 1,599 | 1,498 | 1,583 |
| TEP | Level 2 | 1,223 | 1,282 | 1,223 | 1,271 |

TEP held the Investment in Lease Debt to maturity in January 2013. This investment was stated at amortized cost, which means the purchase cost was adjusted for the amortization of the premium and discount to maturity.

NOTE 10. UNS ENERGY EARNINGS PER SHARE

We compute basic Earnings Per Share (EPS) by dividing Net Income by the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution that could result if outstanding stock options, share-based compensation awards, or UNS Energy's Convertible Senior Notes were exercised or converted into Common Stock. We excluded anti-dilutive stock options and contingently issuable shares from the calculation of diluted EPS.

The following table illustrates the effect of dilutive securities on net income and weighted average Common Stock outstanding:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Dollars | |
| Numerator: Net Income | $11,345 | $6,476 |
| | Thousands of Shares | |
| Denominator: | | |
| Weighted Average Shares of Common Stock Outstanding: | | |
| Common Shares Issued | 41,381 | 37,893 |
| Fully Vested Deferred Stock Units | 159 | 138 |
| Total Weighted Average Common Stock Outstanding – Basic | 41,540 | 38,031 |
| Effect of Dilutive Securities: | | |
| Options and Stock Issuable Under Share-Based Compensation Plans | 335 | 290 |
| Total Weighted Average Common Stock Outstanding – Diluted | 41,875 | 38,321 |

We excluded the following contingently issuable shares and outstanding options, with an exercise price above market, from our diluted EPS computation as their effect would be anti-dilutive:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Shares | |
| Shares from Potential Conversion of Convertible Senior Notes | — | 3,340 |
| Stock Options | — | 101 |
| Restricted Stock Units | 24 | — |
| Total Anti-Dilutive Shares Excluded from the Diluted EPS Computation | 24 | 3,441 |

In 2012, the Convertible Senior Notes were converted to Common Stock or redeemed for cash.

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NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of Net Income to Net Cash Flows from Operating Activities follows:

| | UNS Energy Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Dollars | |
| Net Income | $11,345 | $6,476 |
| Adjustments to Reconcile Net Income To Net Cash Flows from Operating Activities | | |
| Depreciation Expense | 36,300 | 34,984 |
| Amortization Expense | 8,289 | 8,664 |
| Depreciation and Amortization Recorded to Fuel and Operations and Maintenance Expense | 1,759 | 1,644 |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 750 | 808 |
| Provision for Retail Customer Bad Debts | 318 | 706 |
| Use of RECs for Compliance | 3,870 | 1,414 |
| Deferred Income Taxes | 22,078 | 916 |
| Pension and Retiree Expense | 5,696 | 5,463 |
| Pension and Retiree Funding | (1,734) | (2,541) |
| Share-Based Compensation Expense | 722 | 494 |
| Allowance for Equity Funds Used During Construction | (1,175) | (850) |
| Decrease to Reflect PPFAC/PGA Recovery | (5,368) | (2,561) |
| Changes in Assets and Liabilities which Provided (Used) Cash Exclusive of Changes Shown Separately | | |
| Accounts Receivable | 19,003 | 27,294 |
| Materials and Fuel Inventory | 1,574 | (12,720) |
| Accounts Payable | (13,458) | (17,163) |
| Income Taxes | (16,028) | (73) |
| Interest Accrued | (9,974) | (13,191) |
| Taxes Other Than Income Taxes | 12,534 | 10,009 |
| Other | 4,552 | (3,203) |
| Net Cash Flows – Operating Activities | $81,053 | $46,570 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

| | TEP | |
|---|---|---|
| | Three Months Ended March 31, | |
| | 2013 | 2012 |
| | Thousands of Dollars | |
| Net Income (Loss) | $1,478 | $(1,461) |
| Adjustments to Reconcile Net Income (Loss) | | |
| To Net Cash Flows from Operating Activities | | |
| Depreciation Expense | 28,558 | 27,467 |
| Amortization Expense | 9,222 | 9,591 |
| Depreciation and Amortization Recorded to Fuel and Operations and Maintenance Expense | 1,493 | 1,248 |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 601 | 525 |
| Provision for Retail Customer Bad Debts | 246 | 434 |
| Use of RECs for Compliance | 3,540 | 1,217 |
| Deferred Income Taxes | 12,276 | (1,600) |
| Pension and Retiree Expense | 4,970 | 4,821 |
| Pension and Retiree Funding | (1,676) | (2,185) |
| Share-Based Compensation Expense | 575 | 390 |
| Allowance for Equity Funds Used During Construction | (850) | (675) |
| Decrease to Reflect PPFAC Recovery | (2,360) | (7,686) |
| Changes in Assets and Liabilities which Provided (Used) | | |
| Cash Exclusive of Changes Shown Separately | | |
| Accounts Receivable | 11,408 | 17,956 |
| Materials and Fuel Inventory | 1,654 | (12,660) |
| Accounts Payable | (6,094) | (10,240) |
| Income Taxes | (10,877) | (618) |
| Interest Accrued | (6,826) | (8,004) |
| Taxes Other Than Income Taxes | 10,068 | 7,985 |
| Other | 1,993 | (4,954) |
| Net Cash Flows – Operating Activities | $59,399 | $21,551 |

Non-Cash Transactions

In March 2013, TEP issued $91 million of tax-exempt bonds and used the proceeds to redeem debt using a trustee. Since the cash flowed through a trust account, the issuance and redemption of debt resulted in a non-cash transaction. See Note 4.

In the first quarter of 2012, UNS Energy partially converted $73 million of the previously outstanding $150 million Convertible Senior Notes into Common Stock, resulting in a non-cash transaction.

In March 2012, TEP's redemption of $184 million of tax-exempt bonds resulted in a non-cash transaction.

NOTE 12. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

RISKS AND OVERVIEW

We are exposed to energy price risk associated with our gas and purchased power requirements, volumetric risk associated with our seasonal load, and operational risk associated with our generating facilities, transmission, and transportation systems. We reduce our energy price risk through a variety of derivative and non-derivative instruments. The objectives for entering into such contracts include: creating price stability; meeting load and reserve requirements; and reducing exposure to price volatility that may result from delayed recovery under the PPFAC or PGA. See Notes 2 and 9.

We consider the effect of counterparty credit risk in determining the fair value of derivative instruments that are in a net asset position, after incorporating collateral posted by counterparties, and allocate the credit risk adjustment to individual contracts.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

We also consider the impact of our own credit risk after considering collateral posted on instruments that are in a net liability position and allocate the credit risk adjustment to all individual contracts.

FINANCIAL IMPACT OF DERIVATIVES

Cash Flow Hedges

UNS Energy and TEP had liabilities related to cash flow hedges of $11 million as of March 31, 2013 and $12 million as of December 31, 2012. A portion of these cash flow hedges relate to TEP's power purchase swap agreement which expires in 2015.

The after-tax unrealized gains and losses on cash flow hedge activities and amounts reclassified to earnings are reported in the statements of other comprehensive income and Note 13. The amounts reclassified to earnings are reported in Interest Expense - Long-Term Debt and Interest Expense - Capital Leases in the income statements. The amounts expected to be reclassified to earnings within the next twelve months is estimated to be $4 million.

Regulatory Treatment of Commodity Derivatives

We disclose unrealized gains and losses on energy contracts that are recoverable through the PPFAC or PGA on the balance sheets as a regulatory asset or a regulatory liability rather than reporting the transaction in the statements of other comprehensive income or in the income statements, as shown in the following table:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Three Months Ended March 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Increase (Decrease) to Regulatory Assets/Liabilities | $(9) | $8 | $(2) | $5 |

The fair values of commodity derivative assets and liabilities were as follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | March 31, 2013 | December 31, 2012 | March 31, 2013 | December 31, 2012 |
| | Millions of Dollars | | | |
| Assets | $9 | $7 | $5 | $4 |
| Liabilities | (8) | (15) | (3) | (4) |
| Net Assets (Liabilities) | $1 | $(8) | $2 | $— |

Derivative assets are included in Derivative Instruments and Other Assets on the UNS Energy balance sheet and Current Assets - Other and Other Assets on the TEP balance sheet.

The realized losses on settled gas swaps that are fully recoverable through the PPFAC or PGA were as follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Three Months Ended March 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Realized Losses on Settled Gas Swaps | $3 | $7 | $1 | $2 |

At March 31, 2013, UNS Energy and TEP had contracts that will settle through the first quarter of 2016.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

Other Commodity Derivatives
The settlement of forward purchased power and sales contracts that do not result in physical delivery were reflected in the financial statements of UNS Energy and TEP as follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Three Months Ended March 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Recorded in Wholesale Sales: | | | | |
| Forward Power Sales | $4 | $5 | $2 | $1 |
| Forward Power Purchases | (5) | (5) | (2) | (2) |
| Total Sales and Purchases Not Resulting in Physical Delivery | $(1) | $— | $— | $(1) |

Derivatives with Netting Arrangements
The majority of our derivatives contracts include netting arrangements which allow for net payment upon settlement. We present derivatives gross on the balance sheets. The following tables present the balances of derivatives with netting arrangements and the effect if the balances were presented net:

| | Gross Amounts Recognized | Gross Amounts of Derivative Instruments Not Offset in the Balance Sheets | Net Amount |
|---|---|---|---|
| | UNS Energy | | |
| | March 31, 2013 | | |
| | Millions of Dollars | | |
| Derivative Assets | $9 | $(9) | $— |
| Derivative Liabilities | (17) | 9 | (8) |
| | December 31, 2012 | | |
| Derivative Assets | $7 | $(7) | $— |
| Derivative Liabilities | (26) | 7 | (19) |
| | TEP | | |
| | March 31, 2013 | | |
| Derivative Assets | $5 | $(5) | $— |
| Derivative Liabilities | (12) | 5 | (7) |
| | December 31, 2012 | | |
| Derivative Assets | $4 | $(4) | $— |
| Derivative Liabilities | (14) | 4 | (10) |

DERIVATIVE VOLUMES
At March 31, 2013, UNS Energy had gas contracts totaling 19,751 billion British thermal units (GBtu) and power contracts totaling 2,327 Gigawatt-hours (GWh), while TEP had gas contracts totaling 8,774 GBtu and power contracts totaling 990 GWh. At December 31, 2012, UNS Energy had gas contracts totaling 17,851 GBtu and power contracts totaling 2,228 GWh, while TEP had gas contracts totaling 7,958 GBtu and power contracts totaling 820 GWh.

CREDIT RISK ADJUSTMENT

When the fair value of our derivative contracts is reflected as an asset, the counterparty owes us and this creates credit risk. We also consider the impact of our own credit risk on instruments that are in a net liability position. The impact of counterparty credit risk and our own credit risk on the fair value of derivative asset contracts was less than $0.1 million at March 31, 2013 and at December 31, 2012.

CONCENTRATION OF CREDIT RISK

The following table shows the sum of the fair value of all derivative instruments under contracts with credit risk-related contingent features that are in a net liability position at March 31, 2013. It also shows additional collateral to be posted if credit-risk contingent features are triggered.

| | UNS Energy | TEP |
|---|---|---|
| | March 31, 2013 | |
| | Millions of Dollars | |
| Net Liability Position | $15 | $3 |
| Additional Collateral to Post if Contingent Features Triggered | 15 | 3 |

At March 31, 2013, TEP had $12 million of credit exposure to other counterparties' creditworthiness related to its wholesale marketing and gas hedging activities, of which three counterparties composed 52% of the total cre