UNS Energy Corp
Form 10-Q
November 07, 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 September 30, 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 (An Arizona Corporation) 88 East Broadway Boulevard Tucson, AZ 85701 (520) 571-4000	86-0786732
1-5924	TUCSON ELECTRIC POWER COMPANY (An Arizona Corporation) 88 East Broadway Boulevard Tucson, AZ 85701 (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 October 25, 2013, 41,537,582 shares of UNS Energy Corporation Common Stock, no par value (the only class of Common Stock), were outstanding. As of October 25, 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 third 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 TEP Rate Order	A rate order issued by the ACC resulting in a new rate structure for TEP, effective July 1, 2013
2013 UNS Electric Settlement Agreement	A rate settlement agreement entered into by UNS Electric and various other parties
ACC	Arizona Corporation Commission
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
BLM	Bureau of Land Management
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
Entegra	Entegra Power Group LLC
EPA	Environmental Protection Agency
EPS	Earnings Per Share
ESP	Electric Service Providers
FAA	Federal Arbitration Act
FASB	Financial Accounting Standards Board
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)

Gila River Unit 3	Unit 3 of the Gila River Generating Station

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
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
NMED	New Mexico Environmental Department
NSP	Negotiated Sales Program. A program in which UNS Gas sells natural gas to some of its large transportation customers.
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 9 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
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

SJCC	San Juan Coal Company
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
Sulfur Credits	Credits applied to the fuel invoice by the supplier when the sulfur content of delivered coal exceeds contractual levels
Sundt	H. Wilson Sundt Generating Station
Sundt Unit 4	Unit 4 of the H. Wilson Sundt Generating Station
TCA	Transmission Cost Adjustor
Tenth Circuit	The United States Court of Appeals for the Tenth Circuit
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 (formerly 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 September 30, 2013, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2013 and 2012, the condensed consolidated statements of comprehensive income for the three-month and nine-month periods ended September 30, 2013 and 2012, the condensed consolidated statement of changes in stockholders’ equity for the nine-month period ended September 30, 2013 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 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
November 6, 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 September 30, 2013, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2013 and 2012, the condensed consolidated statements of comprehensive income for the three-month and nine-month periods ended September 30, 2013 and 2012, the condensed consolidated statement of changes in stockholder’s equity for the nine-month period ended September 30, 2013 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 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
November 6, 2013

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

Three Months Ended September 30, 2013	2012		Nine Months Ended September 30, 2013	2012
(Unaudited) Thousands of Dollars (Except Per Share Amounts)			(Unaudited) Thousands of Dollars (Except Per Share Amounts)	
		Operating Revenues		
$362,244	$353,473	Electric Retail Sales	$868,523	$850,975
27,529	29,341	Electric Wholesale Sales	92,581	88,469
15,430	15,407	Gas Retail Sales	86,432	85,621
31,838	35,887	Other Revenues	86,863	88,427
437,041	434,108	Total Operating Revenues	1,134,399	1,113,492
		Operating Expenses		
85,102	92,873	Fuel	253,249	245,933
67,429	57,085	Purchased Energy	189,384	165,078
8,061	4,500	Transmission and Other PPFAC Recoverable Costs	15,768	10,738
(3,521)	18,076	Increase (Decrease) to Reflect PPFAC/PGA Recovery Treatment	(6,814)	29,730
157,071	172,534	Total Fuel and Purchased Energy	451,587	451,479
93,202	98,346	Operations and Maintenance	278,245	283,587
38,204	35,145	Depreciation	111,175	105,319
5,193	9,069	Amortization	21,600	26,845
13,606	12,605	Taxes Other Than Income Taxes	41,329	37,385
307,276	327,699	Total Operating Expenses	903,936	904,615
129,765	106,409	Operating Income	230,463	208,877
		Other Income (Deductions)		
2	340	Interest Income	31	981
2,044	1,011	Other Income	5,545	3,855
(438)	(752)	Other Expense	(1,817)	(1,508)
731	581	Appreciation (Depreciation) in Fair Value of Investments	1,864	1,621
2,339	1,180	Total Other Income (Deductions)	5,623	4,949
		Interest Expense		
17,580	17,074	Long-Term Debt	53,534	53,811
6,323	8,507	Capital Leases	18,821	25,105
230	692	Other Interest Expense	183	1,712
(933)	(459)	Interest Capitalized	(2,352)	(1,646)
23,200	25,814	Total Interest Expense	70,186	78,982
108,904	81,775	Income Before Income Taxes	165,900	134,844
40,914	31,111	Income Tax Expense	51,947	51,430
$67,990	$50,664	Net Income	$113,953	$83,414
		Weighted-Average Shares of Common Stock Outstanding (000)		
41,650	41,446	Basic	41,596	39,983
42,028	41,863	Diluted	41,941	41,719
		Earnings Per Share		
$1.63	$1.22	Basic	$2.74	$2.09

$1.62	$1.21	Diluted	$2.72	$2.03
$0.435	$0.43	Dividends Declared Per Share	$1.305	$1.29

See Notes to Condensed Consolidated Financial Statements.

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Three Months Ended September 30,			Nine Months Ended September 30,	
2013	2012		2013	2012
(Unaudited)			(Unaudited)	
Thousands of Dollars			Thousands of Dollars	
		Comprehensive Income		
$67,990	$50,664	Net Income	$113,953	$83,414
		Other Comprehensive Income		
		Net Changes in Fair Value of Cash Flow Hedges:		
685	370	net of income tax expense of $(448) and $(244)		
		net of income tax expense of $(1,459) and $(421)	2,229	641
		Supplemental Executive Retirement Plan (SERP) Benefit Amortization:		
68	55	net of income tax expense of $(42) and $(34)		
		net of income tax expense of $(127) and $(50)	205	219
753	425	Total Other Comprehensive Income, Net of Income Tax Expense	2,434	860
$68,743	$51,089	Total Comprehensive Income	$116,387	$84,274

See Notes to Condensed Consolidated Financial Statements.

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2013	2012
	(Unaudited)	
	Thousands of Dollars	
Cash Flows from Operating Activities		
Cash Receipts from Electric Retail Sales	$912,098	$894,195
Cash Receipts from Electric Wholesale Sales	118,341	107,854
Cash Receipts from Gas Retail Sales	109,994	114,055
Cash Receipts from Operating Springerville Units 3 & 4	75,552	75,715
Cash Receipts from Gas Wholesale Sales	3,558	565
Interest Received	516	2,884
Income Tax Refunds Received	—	307
Other Cash Receipts	23,514	18,810
Fuel Costs Paid	(218,712)	(239,397)
Purchased Energy Costs Paid	(217,522)	(189,927)
Payment of Operations and Maintenance Costs	(199,939)	(207,780)
Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized	(124,782)	(128,513)
Wages Paid, Net of Amounts Capitalized	(96,899)	(94,815)
Interest Paid, Net of Amounts Capitalized	(50,108)	(52,593)
Capital Lease Interest Paid	(21,698)	(27,895)
Income Taxes Paid	(316)	—
Other Cash Payments	(8,563)	(5,327)
Net Cash Flows—Operating Activities	305,034	268,138
Cash Flows from Investing Activities		
Capital Expenditures	(238,463)	(232,036)
Purchase of Intangibles—Renewable Energy Credits	(20,429)	(7,554)
Deposit—San Juan Mine Reclamation Trust	—	(1,107)
Other Cash Payments	—	(232)
Return of Investments in Springerville Lease Debt	9,104	19,278
Restricted Cash Released	4,500	—
Proceeds from Note Receivable	—	12,500
Insurance Proceeds for Replacement Assets	—	2,875
Other Cash Receipts	6,625	14,484
Net Cash Flows—Investing Activities	(238,663)	(191,792)
Cash Flows from Financing Activities		
Proceeds from Borrowings Under Revolving Credit Facilities	130,000	342,000
Repayments of Borrowings Under Revolving Credit Facilities	(100,000)	(346,000)
Payments of Capital Lease Obligations	(99,621)	(89,452)
Common Stock Dividends Paid	(54,146)	(51,852)
Proceeds from Issuance of Long-Term Debt	—	149,513
Repayments of Long-Term Debt	—	(9,341)
Payment of Debt Issue/Retirement Costs	(1,022)	(3,349)
Proceeds from Stock Options Exercised	2,724	3,529
Proceeds from Common Stock Issuance	408	—
Other Cash Receipts	4,721	2,935
Other Cash Payments	(962)	(718)
Net Cash Flows—Financing Activities	(117,898)	(2,735)

Net Increase (Decrease) in Cash and Cash Equivalents	(51,527)	73,611
Cash and Cash Equivalents, Beginning of Year	123,918	76,390
Cash and Cash Equivalents, End of Period	$72,391	$150,001

See Note 10 for supplemental cash flow information.
See Notes to Condensed Consolidated Financial Statements.

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2013 (Unaudited)	December 31, 2012
	Thousands of Dollars	
ASSETS		
Utility Plant		
Plant in Service	$5,114,426	$5,005,768
Utility Plant Under Capital Leases	621,247	582,669
Construction Work in Progress	211,100	128,621
Total Utility Plant	5,946,773	5,717,058
Less Accumulated Depreciation and Amortization	(1,966,801)	(1,921,733)
Less Accumulated Amortization of Capital Lease Assets	(509,712)	(494,962)
Total Utility Plant—Net	3,470,260	3,300,363
Investments and Other Property		
Investments in Lease Equity	36,230	36,339
Other	33,441	36,537
Total Investments and Other Property	69,671	72,876
Current Assets		
Cash and Cash Equivalents	72,391	123,918
Accounts Receivable—Customer	127,316	93,742
Unbilled Accounts Receivable	55,730	53,568
Allowance for Doubtful Accounts	(7,215)	(6,545)
Materials and Supplies	89,302	93,322
Fuel Inventory	44,458	62,019
Deferred Income Taxes—Current	66,520	34,260
Regulatory Assets—Current	52,709	51,619
Investments in Lease Debt	—	9,118
Derivative Instruments	1,620	3,165
Other	26,882	33,567
Total Current Assets	529,713	551,753
Regulatory and Other Assets		
Regulatory Assets—Noncurrent	200,705	191,077
Derivative Instruments	752	3,801
Other Assets	22,704	20,559
Total Regulatory and Other Assets	224,161	215,437
Total Assets	$4,293,805	$4,140,429

See Notes to Condensed Consolidated Financial Statements.

(Continued)

UNS ENERGY CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2013 (Unaudited)	December 31, 2012
	Thousands of Dollars	
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity	$1,132,286	$1,065,465
Capital Lease Obligations	130,088	262,138
Long-Term Debt	1,505,536	1,498,442
Total Capitalization	2,767,910	2,826,045
Current Liabilities		
Current Obligations Under Capital Leases	169,060	90,583
Borrowings Under Revolving Credit Facilities	23,000	—
Accounts Payable—Trade	91,615	107,740
Accrued Taxes Other than Income Taxes	60,657	41,939
Accrued Employee Expenses	26,000	24,094
Accrued Interest	22,343	31,950
Regulatory Liabilities—Current	56,987	43,516
Customer Deposits	30,564	34,048
Derivative Instruments	12,988	14,742
Other	14,521	10,517
Total Current Liabilities	507,735	399,129
Deferred Credits and Other Liabilities		
Deferred Income Taxes—Noncurrent	482,516	364,756
Regulatory Liabilities—Noncurrent	297,699	279,111
Pension and Other Retiree Benefits	141,997	159,401
Derivative Instruments	7,183	12,709
Other	88,765	99,278
Total Deferred Credits and Other Liabilities	1,018,160	915,255
Commitments, Contingencies, and Environmental Matters (Note 4)		
Total Capitalization and Other Liabilities	$4,293,805	$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			113,953		113,953
Other Comprehensive Income, net of $(1,586) income taxes				2,434	2,434
Total Comprehensive Income					116,387
Dividends, Including Non-Cash Dividend Equivalents			(54,733)		(54,733)
Shares Issued Under Dividend Reinvestment Plan	9	408			408
Shares Issued for Stock Options	85	2,724			2,724
Shares Issued Under Performance Share Awards	57	—			—
Other		2,035			2,035
Balances at September 30, 2013	41,495	$887,305	$252,337	$ (7,356)	$1,132,286

* 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

Three Months Ended September 30, 2013	2012		Nine Months Ended September 30, 2013	2012
(Unaudited)			(Unaudited)	
Thousands of Dollars			Thousands of Dollars	
		Operating Revenues		
$310,632	$302,893	Electric Retail Sales	$739,147	$716,993
26,563	25,448	Electric Wholesale Sales	90,503	77,488
34,044	38,569	Other Revenues	93,603	95,826
371,239	366,910	Total Operating Revenues	923,253	890,307
		Operating Expenses		
82,065	88,402	Fuel	247,417	237,930
42,477	27,576	Purchased Power	89,815	62,064
4,940	1,914	Transmission and Other PPFAC Recoverable Costs	7,535	4,277
(7,992)	20,025	Increase (Decrease) to Reflect PPFAC Recovery Treatment	(5,079)	25,150
121,490	137,917	Total Fuel and Purchased Energy	339,688	329,421
79,335	86,942	Operations and Maintenance	239,170	248,092
30,311	27,644	Depreciation	87,729	82,656
6,118	10,001	Amortization	24,393	29,621
10,808	10,327	Taxes Other Than Income Taxes	32,916	30,325
248,062	272,831	Total Operating Expenses	723,896	720,115
123,177	94,079	Operating Income	199,357	170,192
		Other Income (Deductions)		
6	28	Interest Income	14	97
1,466	952	Other Income	3,904	3,041
(2,776)	(1,945)	Other Expense	(7,493)	(4,886)
731	581	Appreciation (Depreciation) in Fair Value of Investments	1,864	1,621
(573)	(384)	Total Other Income (Deductions)	(1,711)	(127)
		Interest Expense		
13,848	13,268	Long-Term Debt	42,412	40,562
6,323	8,507	Capital Leases	18,821	25,105
82	562	Other Interest Expense	(86)	1,338
(644)	(361)	Interest Capitalized	(1,671)	(1,381)
19,609	21,976	Total Interest Expense	59,476	65,624
102,995	71,719	Income Before Income Taxes	138,170	104,441
38,828	27,150	Income Tax Expense	41,737	39,423
$64,167	$44,569	Net Income	$96,433	$65,018

See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Three Months Ended September 30,			Nine Months Ended September 30,	
2013	2012		2013	2012
(Unaudited)			(Unaudited)	
Thousands of Dollars			Thousands of Dollars	
		Comprehensive Income		
$64,167	$44,569	Net Income	$96,433	$65,018
		Other Comprehensive Income		
		Net Changes in Fair Value of Cash Flow Hedges:		
700	465	net of income tax expense of $(458) and $(304)		
		net of income tax expense of $(1,412) and $(584)	2,156	891
		SERP Benefit Amortization:		
68	55	net of income tax expense of $(42) and $(34)		
		net of income tax expense of $(127) and $(50)	205	219
768	520	Total Other Comprehensive Income, Net of Income Tax Expense	2,361	1,110
$64,935	$45,089	Total Comprehensive Income	$98,794	$66,128

See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2013	2012
	(Unaudited)	
	Thousands of Dollars	
Cash Flows from Operating Activities		
Cash Receipts from Electric Retail Sales	$769,433	$748,936
Cash Receipts from Electric Wholesale Sales	107,997	89,902
Cash Receipts from Operating Springerville Units 3 & 4	75,552	75,715
Reimbursement of Affiliate Charges	17,639	16,783
Cash Receipts from Gas Wholesale Sales	3,209	153
Interest Received	509	2,014
Income Tax Refunds Received	77	200
Other Cash Receipts	18,240	14,528
Fuel Costs Paid	(214,722)	(233,457)
Payment of Operations and Maintenance Costs	(193,290)	(200,569)
Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized	(97,419)	(99,249)
Purchased Power Costs Paid	(87,110)	(60,684)
Wages Paid, Net of Amounts Capitalized	(80,964)	(77,820)
Interest Paid, Net of Amounts Capitalized	(36,671)	(35,728)
Capital Lease Interest Paid	(21,698)	(27,893)
Income Taxes Paid	—	(1,796)
Other Cash Payments	(6,603)	(3,884)
Net Cash Flows—Operating Activities	254,179	207,151
Cash Flows from Investing Activities		
Capital Expenditures	(180,451)	(196,429)
Purchase of Intangibles—Renewable Energy Credits	(17,552)	(6,436)
Deposit—San Juan Mine Reclamation Trust	—	(1,107)
Return of Investments in Springerville Lease Debt	9,104	19,278
Restricted Cash Released	4,500	—
Insurance Proceeds for Replacement Assets	—	2,875
Other Cash Receipts	4,656	9,207
Net Cash Flows—Investing Activities	(179,743)	(172,612)
Cash Flows from Financing Activities		
Proceeds from Borrowings Under Revolving Credit Facility	78,000	189,000
Repayments of Borrowings Under Revolving Credit Facility	(78,000)	(199,000)
Payments of Capital Lease Obligations	(99,621)	(89,452)
Dividends Paid to UNS Energy	(20,000)	—
Proceeds from Issuance of Long-Term Debt	—	149,513
Repayments of Long-Term Debt	—	(6,535)
Payment of Debt Issue/Retirement Costs	(1,022)	(3,349)
Other Cash Receipts	1,976	1,292
Other Cash Payments	(726)	(530)
Net Cash Flows—Financing Activities	(119,393)	40,939
Net Increase (Decrease) in Cash and Cash Equivalents	(44,957)	75,478
Cash and Cash Equivalents, Beginning of Year	79,743	27,718

Cash and Cash Equivalents, End of Period	$34,786	$103,196

See Note 10 for supplemental cash flow information.
See Notes to Condensed Consolidated Financial Statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2013 (Unaudited)	December 31, 2012
	Thousands of Dollars	
ASSETS		
Utility Plant		
Plant in Service	$4,434,770	$4,348,041
Utility Plant Under Capital Leases	621,247	582,669
Construction Work in Progress	153,258	98,460
Total Utility Plant	5,209,275	5,029,170
Less Accumulated Depreciation and Amortization	(1,811,806)	(1,783,787)
Less Accumulated Amortization of Capital Lease Assets	(509,712)	(494,962)
Total Utility Plant—Net	2,887,757	2,750,421
Investments and Other Property		
Investments in Lease Equity	36,230	36,339
Other	32,009	35,091
Total Investments and Other Property	68,239	71,430
Current Assets		
Cash and Cash Equivalents	34,786	79,743
Accounts Receivable—Customer	105,646	71,813
Unbilled Accounts Receivable	46,240	33,782
Allowance for Doubtful Accounts	(5,238)	(4,598)
Accounts Receivable—Due from Affiliates	3,963	5,720
Materials and Supplies	76,255	80,377
Fuel Inventory	44,162	61,737
Deferred Income Taxes—Current	69,985	37,212
Regulatory Assets—Current	36,283	34,345
Investments in Lease Debt	—	9,118
Derivative Instruments	1,047	2,230
Other	20,605	32,163
Total Current Assets	433,734	443,642
Regulatory and Other Assets		
Regulatory Assets—Noncurrent	186,626	178,330
Derivative Instruments	259	1,354
Other Assets	17,525	15,869
Total Regulatory and Other Assets	204,410	195,553
Total Assets	$3,594,140	$3,461,046

See Notes to Condensed Consolidated Financial Statements.
(Continued)

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2013 (Unaudited)	December 31, 2012
	Thousands of Dollars	
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity	$939,721	$860,927
Capital Lease Obligations	130,088	262,138
Long-Term Debt	1,223,536	1,223,442
Total Capitalization	2,293,345	2,346,507
Current Liabilities		
Current Obligations Under Capital Leases	169,060	90,583
Accounts Payable—Trade	75,834	82,122
Accounts Payable—Due to Affiliates	2,981	3,134
Accrued Taxes Other than Income Taxes	50,465	33,060
Accrued Employee Expenses	22,937	20,715
Accrued Interest	20,503	26,965
Regulatory Liabilities—Current	26,440	20,822
Customer Deposits	21,251	24,846
Derivative Instruments	7,060	4,899
Other	9,336	7,085
Total Current Liabilities	405,867	314,231
Deferred Credits and Other Liabilities		
Deferred Income Taxes—Noncurrent	421,621	319,216
Regulatory Liabilities—Noncurrent	259,523	241,189
Pension and Other Retiree Benefits	132,491	149,718
Derivative Instruments	4,950	10,565
Other	76,343	79,620
Total Deferred Credits and Other Liabilities	894,928	800,308
Commitments, Contingencies, and Environmental Matters (Note 4)		
Total Capitalization and Other Liabilities	$3,594,140	$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 Earnings (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			96,433		96,433
Other Comprehensive Income, net of $(1,539) income taxes				2,361	2,361
Total Comprehensive Income					98,794
Dividends Paid			(20,000)		(20,000)
Balances at September 30, 2013	$888,971	$(6,357)	$64,276	$ (7,169)	$939,721

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 our 2012 Annual Report on Form 10-K.
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 an equal and offsetting overstatement of Electric Wholesale Sales and Purchased Energy in the income statements of $3 million for the three months ended and $10 million for the nine months ended September 30, 2012. This error had no impact on operating income, net income, accumulated 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			
	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	As Reported	As Revised	As Reported	As Revised
	Thousands of Dollars		Thousands of Dollars	
Income Statement				
Electric Wholesale Sales	$32,494	$29,341	$98,282	$88,469
Purchased Energy	60,238	57,085	174,891	165,078
Total Fuel and Purchased Energy	175,687	172,534	461,292	451,479
Total Operating Expenses	330,852	327,699	914,428	904,615

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In 2013, we adopted authoritative guidance that:
- Requires disclosure related to offsetting derivative assets and derivative liabilities in accordance with GAAP. See Note 11.
- Requires additional disclosures for amounts reclassified out of Accumulated Other Comprehensive Income (AOCI) by component. See Note 12.
- Allows an entity to perform a qualitative analysis to determine if additional testing for impairment of indefinite-lived intangible assets is required. Based on our qualitative analysis, we had no impairment indicator as our only

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.

2013 TEP RATE ORDER

In June 2013, the ACC issued the 2013 TEP Rate Order that resolved the rate case filed by TEP in July 2012 which was based on a test year ended December 31, 2011. The 2013 TEP Rate Order approved new rates effective July 1, 2013.

The provisions of the 2013 TEP Rate Order include, but are not limited to:

- an increase in non-fuel retail Base Rates of approximately $76 million over adjusted test year revenues;
- an Original Cost Rate Base (OCRB) of approximately $1.5 billion and a Fair Value Rate Base (FVRB) of approximately $2.3 billion;
- a return on equity of 10.0%, a long-term cost of debt of 5.18%, and a short-term cost of debt of 1.42%, resulting in a weighted average cost of capital of 7.26%;
- a capital structure of approximately 43.5% equity, 56.0% long-term debt, and 0.5% short-term debt;
- a 0.68% 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);
- a revision in depreciation rates from an average rate of 3.32% to 3.0% for generation and distribution plant, primarily due to revised estimates of asset removal costs, which will have the effect of reducing depreciation expense by approximately $11 million annually; and
- an agreement by TEP to seek recovery of costs related to the Nogales transmission line from the FERC before seeking rate recovery from the ACC.

The 2013 TEP Rate Order also includes the following cost recovery mechanisms:

- a new Purchased Power and Fuel Adjustment Clause (PPFAC) credit of $0.001388 per kWh effective July 1, 2013. The credit reflects the following:
  - a one-time reduction in the PPFAC bank balance, recorded in June 2013 as an increase to fuel expense, of $3 million related to prior Sulfur Credits; and
  - a transfer of $10 million, recorded in June 2013, from the PPFAC bank balance to a new regulatory asset to defer coal costs related to the San Juan mine fire. These costs will be eligible for recovery through the PPFAC upon final insurance settlement.
- a modification of the PPFAC mechanism to include recovery of generation-related lime costs offset by Sulfur Credits.

- a Lost Fixed Cost Recovery mechanism (LFCR) to recover certain non-fuel costs related to kWh sales lost due to energy efficiency programs and distributed generation, subject to ACC approval and a year-over-year cap of 1% of TEP's total retail revenues. TEP expects the LFCR rate, recovering 2013 costs, to be effective on July 1, 2014, upon approval of verified lost kWh sales by the ACC.

- an Environmental Compliance Adjustor (ECA) mechanism to recover certain capital carrying costs to comply with government-mandated environmental regulations between rate cases. The ECA rate is capped at $0.00025 per kWh, which approximates 0.25% of TEP's total retail revenues, and will be charged to customers beginning in May 2014 for any qualifying costs incurred between August 2013 and December 2013.

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- an energy efficiency provision which includes a 2013 calendar year budget to fund programs that support the ACC's Electric Energy Efficiency Standards, as well as a performance incentive.

PENDING UNS ELECTRIC RATE CASE

In December 2012, UNS Electric filed a rate case application with the ACC as required by the ACC in UNS Electric's 2010 Rate Order. UNS Electric's rate filing was based on a test year ended June 30, 2012.

In September 2013, UNS Electric, the staff of the ACC, and certain other parties to UNS Electric's pending rate case proceeding entered into a settlement agreement (2013 UNS Electric Settlement Agreement). The 2013 UNS Electric Settlement Agreement requires the approval of the ACC before new rates can become effective.

The terms of the 2013 UNS Electric Settlement Agreement include, but are not limited to:

- an increase in non-fuel retail Base Rates of approximately $3 million;

- an OCRB of approximately $213 million and a FVRB of approximately $283 million;

- a return on equity of 9.50% and a long-term cost of debt of 5.97% resulting in a weighted average cost of capital of 7.83%;

- a 0.50% 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 $70 million); and

- a capital structure of 52.6% equity and 47.4% long-term debt.

The 2013 UNS Electric Settlement Agreement also includes the following cost recovery mechanisms:

- an LFCR mechanism to recover certain non-fuel costs related to kWh sales lost due to energy efficiency programs and distributed generation; and

- a Transmission Cost Adjustor (TCA). The TCA would allow more timely recovery of transmission costs associated with serving retail customers.

UNS GAS PURCHASED GAS ADJUSTOR

In October 2013, the ACC approved an increase to the existing Purchased Gas Adjustor (PGA) credit from 4.5 cents per therm to 10 cents per therm in order to reduce the over-collected PGA bank balance. The new PGA credit will be effective for the period November 1, 2013 through April 30, 2014. At September 30, 2013, the PGA bank balance was over-collected by $17 million on a billed-to-customer basis.

REGULATORY ASSETS AND LIABILITIES

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

	September 30, 2013		December 31, 2012	
	UNS Energy	TEP	UNS Energy	TEP
	Millions of Dollars			
Regulatory Assets – Current	$53	$36	$52	$34
Regulatory Assets – Noncurrent[1]	201	187	191	178

Regulatory Liabilities – Current[2]	(57)	(26)	(44)	(21)
Regulatory Liabilities – Noncurrent[3]	(298)	(260)	(279)	(241)
Total Net Regulatory Assets (Liabilities)	$(101)	$(63)	$(80)	$(50)

(1) Regulatory Assets – Noncurrent increased reflecting a newly created regulatory asset primarily for the investment tax credit basis adjustment. See Note 6. This regulatory asset does not earn a return and will be recovered through future

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rates. The increase is also related to the addition of deferred rate case costs that do not earn a return and will be recovered over a four year period.

(2) Regulatory Liabilities – Current increased because purchased energy costs are over recovered following deferral of coal costs related to the San Juan mine fire, as discussed above. The regulatory asset related to these deferred costs does not earn a return and will be recovered at the time of the final insurance settlement.

(3) Regulatory Liabilities – Noncurrent increased due to the collection of amounts in rates for future asset removal costs that have not yet been expended.

FUTURE IMPLICATIONS OF DISCONTINUING APPLICATION OF REGULATORY ACCOUNTING

If our regulated operations no longer met the requirements to apply regulatory accounting we would remove our regulatory assets and liabilities by:

- writing off the remaining regulatory assets as an expense and regulatory liabilities as income in the income statements; and
- reflecting regulatory pension assets as part of AOCI.

If we had stopped applying regulatory accounting at September 30, 2013:

- TEP would have recorded an extraordinary after-tax gain of $113 million and an after-tax loss in AOCI of $75 million;
- UNS Gas would have recorded an extraordinary after-tax gain of $26 million and an after-tax loss in AOCI of $2 million; and
- UNS Electric would have recorded an extraordinary after-tax gain of $3 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 and our largest subsidiary
(2) UNS Gas, a regulated gas distribution utility
(3) UNS Electric, a regulated electric utility

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

	Reportable Segments					
	TEP	UNS Gas	UNS Electric	Non-Reportable Segments	Reconciling Adjustments	UNS Energy Consolidated
	Millions of Dollars					
Income Statement						
Three Months Ended September 30, 2013						
Operating Revenues – External	$367	$16	$54	$ —	$ —	$ 437
Operating Revenues – Intersegment[1]	4	2	—	4	(10)	—
Net Income	64	(1)	5	—	—	68

Three Months Ended September 30, 2012						
Operating Revenues – External	$362	$16	$56	$ —	$—	$434
Operating Revenues – Intersegment [1]	5	2	—	5	(12)	—
Net Income	45	—	6	—	—	51

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	Reportable Segments					
	TEP	UNS Gas	UNS Electric	Non-Reportable Segments	Reconciling Adjustments	UNS Energy Consolidated
	Millions of Dollars					
Income Statement						
Nine Months Ended September 30, 2013						
Operating Revenues – External	$910	$90	$134	$ —	$—	$ 1,134
Operating Revenues – Intersegment(1)	13	3	1	12	(29)	—
Net Income	96	6	11	1	—	114
Nine Months Ended September 30, 2012						
Operating Revenues – External	$877	$89	$147	$ —	$—	$ 1,113
Operating Revenues – Intersegment(1)	13	4	1	14	(32)	—
Net Income	65	5	14	(1)	—	83

(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. COMMITMENTS, CONTINGENCIES, AND ENVIRONMENTAL MATTERS

In addition those reported in our 2012 Annual Report on Form 10-K, we entered into the following new long-term commitments through September 30, 2013:

TEP COMMITMENTS

	Purchase Commitments						
	2013	2014	2015	2016	2017	Thereafter	Total
	Millions of Dollars						
Purchased Power, Including Renewable PPA(1)	$2	$18	$6	$4	$4	$58	$92
Capital Lease Obligations(2)	—	—	46	—	—	—	46
RES Performance-Based Incentives(3)	1	1	1	1	1	7	12
Fuel Transportation(4)	4	5	5	5	5	1	25
Total Purchase Commitments	$7	$24	$58	$10	$10	$66	$175

(1) Purchased Power costs are recoverable from customers through the PPFAC. A portion of the Renewable Power Purchase Agreement (PPA) is recoverable through the PPFAC, with the balance recoverable through the RES tariff.
(2) In the third and fourth quarters of 2013, TEP entered into agreements to purchase certain Springerville Unit 1 leased interests. See Note 5.
(3) The RES Performance-Based Incentive (PBI) costs are recoverable through the RES tariff.
(4) Fuel Transportation costs are recoverable from customers through the PPFAC.

UNS GAS COMMITMENTS

Forward Energy Contracts

UNS Gas entered into new forward energy commitments that settle through 2016 at fixed prices per million British thermal units (MMBtu). UNS Gas' minimum payment obligations for these purchases are $2 million in 2014, $3

million in 2015, and $2 million in 2016.
Fuel Transportation
UNS Gas entered into revised gas transportation agreements in August 2013. UNS Gas anticipates that its commitments will increase by $3 million in 2013, $9 million each year in 2014 through 2016, $10 million in 2017, and $56 million thereafter.

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UNS ELECTRIC COMMITMENTS

Purchased Power Contracts

UNS Electric entered into new forward purchased power commitments that will settle through 2015 at fixed prices per MWh. UNS Electric's minimum payment obligations for these purchases are $1 million in 2014 and $4 million in 2015.

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.

In August 2013, the Bureau of Land Management (BLM) proposed regulations that, among other things, redefine the term "underground mine" to exclude high-wall mining operations and impose a higher surface mine coal royalty on high-wall mining. SJCC utilized high-wall mining techniques at its surface mines prior to beginning underground mining operations in January 2003. If the proposed regulations become effective, SJCC may be subject to additional royalties on coal delivered to San Juan between August 2000 and January 2003 totaling approximately $5 million of which TEP's proportionate share would approximate $1 million. TEP cannot predict the final outcome of the BLM's proposed regulations.

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. All parties filed a joint motion to stay until December 1, 2013.

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.

In May 2013, the New Mexico Taxation and Revenue Department issued a notice of assessment for coal severance tax, penalties, and interest totaling $30 million to the coal supplier at Four Corners. The coal supplier and Four Corners' operating agent intend to contest the validity of the assessment on behalf of the participants in Four Corners, who will be liable for their share of any resulting liabilities. TEP's share of the assessment based on its ownership of Four Corners is approximately $1 million. TEP cannot predict the outcome or timing of resolution of this 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, 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 was $18 million at September 30, 2013 and $16 million at December 31, 2012.

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.

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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. As part of the 2013 TEP Rate Order, TEP agreed to seek recovery of the project costs from FERC before seeking rate recovery from the ACC. See Note 2. 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.

RESOLUTION OF TEP 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 standards, Navajo may require 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. 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. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than $1 million each.

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 require mercury emission control equipment by 2015. TEP's share of 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 require 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.

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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.

Navajo

In January 2013, the EPA proposed a BART determination that would require the installation of Selective Catalytic Reduction (SCR) technology on all three units at Navajo by 2023. In July 2013, SRP, along with other stakeholders including impacted government agencies, environmental organizations, and tribal representatives, submitted an agreement to the EPA that would achieve greater NOx emission reductions than the EPA's proposed BART rule. In September 2013, EPA issued a supplemental proposal incorporating the provisions of the agreement as a better-than-BART alternative.

Among other things, the agreement calls for the shut down of one unit or an equivalent reduction in emissions by 2020. The shutdown of one unit will not impact the total amount of energy delivered to TEP from Navajo. Additionally, the remaining Navajo participants would be required to install SCR or an equivalent technology on the remaining two units by 2030. As part of the agreement, the current owners have committed to cease their operation of conventional coal-fired generation at Navajo no later than December 2044. The Navajo Nation can continue operation after 2044 at its election. If SCR technology is ultimately implemented 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 United States Court of Appeals for the Tenth Circuit (Tenth Circuit). In addition, the operator 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 by PNM 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. The New Mexico Environmental Department (NMED) prepared a revision to the regional haze SIP incorporating the provisions of the agreement, and in September 2013, the New Mexico Environmental Improvement Board approved the SIP revision. The SIP revision now awaits final EPA approval.

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TEP estimates its share of the cost to install SNCR technology on San Juan Unit 1 would be approximately $35 million. TEP's share of incremental annual operating costs for SNCR is estimated at $1 million. TEP owns 340 MW, or 50%, of San Juan Units 1 and 2. At September 30, 2013, the book value of TEP's share of San Juan Unit 2 was $114 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. APS must select which FIP alternative to implement by December 31, 2013. In either case, TEP's estimated share of the capital costs to install SCR technology on Units 4 and 5 is approximately $35 million. TEP's share of incremental annual operating costs for SCR is estimated at $2 million.

Springerville

The BART provisions of the Regional Haze Rules requiring emission control upgrades do not apply to Springerville. Other provisions of the Regional Haze Rule requiring further emission reduction are not likely to impact Springerville operations until after 2018.

Sundt

In July 2013, the EPA rejected the Arizona state implementation plan determination that Sundt Unit 4 is not subject to the BART provisions of the Regional Haze Rule. Under the Regional Haze Rule, 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 December 2013, with a final determination expected in May 2014. While TEP does not agree that Sundt Unit 4 is BART eligible, in anticipation of EPA's proposed BART requirements, TEP has submitted a plan for EPA approval proposing to eliminate coal as a fuel after December 2017.

Greenhouse Gas Regulation

In June 2013, President Obama directed the EPA to move forward with carbon emission regulations for both new and existing fossil-fueled power plants.

In September 2013, the EPA issued a re-proposed rule for new power plants. UNS Energy does not anticipate that a final rule related to new fossil-fueled power plant sources will have a significant impact on operations.

For existing power plants, the President ordered the EPA to:

- propose carbon emission standards by June 1, 2014;
- finalize those standards by June 1, 2015; and
- require states to submit their implementation plans to meet the standards by June 30, 2016.

UNS Energy will continue to work with federal and state regulatory agencies to promote compliance flexibility in the rules impacting existing fossil-fuel fired power plants. We cannot predict the ultimate outcome of these matters.

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NOTE 5. DEBT, CREDIT FACILITIES, AND CAPITAL LEASE OBLIGATIONS

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

TEP SPRINGERVILLE UNIT 1 CAPITAL LEASE PURCHASE COMMITMENTS

In 2011, TEP and the owner participants of Springerville Unit 1 completed a formal appraisal procedure to determine the fair market value purchase price of Springerville Unit 1 in accordance with the Springerville Unit 1 Leases. The purchase price was determined to be $478 per kW of capacity based on a continuous capacity rating of 387 MW. The appraisal price was challenged, and TEP initiated a proceeding in 2012 seeking judicial confirmation of the results of the appraisal process.

In August 2013, TEP elected to purchase leased interests comprising 24.8% of Springerville Unit 1, representing 96 MW of continuous operating capability, for an aggregate purchase price of $46 million, the appraised value, upon the expiration of the lease term in January 2015.

In October 2013, TEP elected to purchase an additional 10.6% leased interest in Springerville Unit 1, representing 41 MW of continuous operating capability, for $20 million, the appraised value, with the purchase scheduled to occur in December 2014.

Upon close of these lease option purchases, TEP will own 49.5% of Springerville Unit 1, or 192 MW of continuous operating capability. Due to TEP's purchase commitment, TEP and UNS Energy expect to record an increase of approximately $55 million to both Utility Plant Under Capital Leases and Capital Lease Obligations on their balance sheets, of which $39 million is reflected as of September 30, 2013.

Because the owner participants whose leased interests TEP elected to purchase have agreed to sell their interests for amounts equal to the appraised value, TEP dismissed the legal action associated with the appraisal.

TEP TAX-EXEMPT BONDS ISSUED

In March 2013, the Industrial Development Authority of Pima County, Arizona issued approximately $91 million aggregate principal amount 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.

UNS ENERGY'S AND TEP'S CREDIT RATING UPGRADES

In June 2013, the pricing under certain debt agreements improved as a result of an upgrade in the credit ratings of UNS Energy and TEP.

- Under the UNS Energy Credit Agreement, the interest rate decreased from London Interbank Offered Rate (LIBOR) plus 1.75% to LIBOR plus 1.5%;
- Under the TEP Credit Agreement, the interest rate decreased from LIBOR plus 1.125% to LIBOR plus 1.0% ; and the margin rate on the $186 million letter of credit facility decreased from 1.125% to 1.0% ; and
- Under the 2010 TEP Reimbursement Agreement, fees payable on outstanding letters of credit decreased from 1.5% to 1.25% per annum.

TEP MORTGAGE INDENTURE

Prior to November 2013, the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement were secured by $423 million in mortgage bonds issued under the 1992 Mortgage. As a result of TEP's credit rating upgrade, in October 2013, TEP (i) requested $423 million in mortgage bonds be returned to TEP for cancellation, and (ii) discharged the 1992 Mortgage, which had created a lien on and security interest in substantially all of TEP’s utility plant assets. TEP’s obligations under the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement are now unsecured, which changed the pricing of the following agreements, with pricing tied to credit ratings for short-term borrowings:

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

- Under the TEP Credit Agreement, the interest rate increased from LIBOR plus 1.0% to LIBOR plus 1.25%; and the margin rate on the $186 million letter of credit facility increased from 1.0% to 1.25%; and

- Under the 2010 TEP Reimbursement Agreement, fees payable on outstanding letters of credit increased from 1.25% to 1.75% per annum.

COVENANT COMPLIANCE

At September 30, 2013, we were in compliance with the terms of our credit agreements, the 2010 TEP Reimbursement Agreement, and UNS Electric's term loan.

NOTE 6. 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 September 30,			
	2013	2012	2013	2012
	Millions of Dollars			
Federal Income Tax Expense at Statutory Rate	$38	$29	$36	$25
State Income Tax Expense, Net of Federal Deduction	5	3	5	3
Federal/State Tax Credits	(1)	(1)	(1)	(1)
Other	(1)	—	(1)	—
Total Federal and State Income Tax Expense	41	$31	$39	$27

	UNS Energy		TEP	
	Nine Months Ended September 30,			
	2013	2012	2013	2012
	Millions of Dollars			
Federal Income Tax Expense at Statutory Rate	$58	$47	$48	$37
State Income Tax Expense, Net of Federal Deduction	8	6	6	4
Federal/State Tax Credits	(2)	(1)	(2)	(1)
Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset	(11)	—	(11)	—
Other	(1)	(1)	1	(1)
Total Federal and State Income Tax Expense	$52	$51	$42	$39

Investment Tax Credit Basis Difference Adjustment

Renewable energy assets are eligible for investment tax credits. We reduce the income tax basis of those qualifying assets by half of the related investment tax credit. Historically, the difference between the income tax basis of the asset and the book basis under GAAP was recorded as a deferred tax liability with an offsetting charge to income tax expense in the year the qualifying asset was placed in service. In June 2013, we recorded a regulatory asset and corresponding reduction of income tax expense of $11 million to recover previously recorded income tax expense through future rates as a result of the 2013 TEP Rate Order. The regulatory asset will be amortized as income tax expense as the qualifying assets are depreciated.

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:

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	UNS Energy	TEP
	Millions of Dollars	
Unrecognized Tax Benefits at December 31, 2012	$30	$23
Additions Based on Tax Positions Taken in the Current Year	1	1
Reduction of Positions from Prior Year Based on Tax Authority Ruling	(27)	(22)
Unrecognized Tax Benefits at September 30, 2013	$4	$2

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 the IRS ruling in the first quarter of 2013, 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 resulting in no change to the financial statements.

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

Tangible Repairs Regulation

In September 2013, the U.S. Treasury Department released final income tax regulations on the deduction and capitalization of expenditures related to tangible property. These final regulations apply to tax years beginning on or after January 1, 2014. Several of the provisions within the regulations will require a tax accounting method change to be filed with the IRS resulting in a cumulative effect adjustment. Management believes that adoption of these regulations will not result in a material change to plant-related deferred tax liabilities.

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 September 30,			
	2013	2012	2013	2012
	Millions of Dollars			
Service Cost	$4	$2	$1	$1
Interest Cost	4	4	—	1
Expected Return on Plan Assets	(5)	(4)	—	—
Actuarial Loss Amortization	2	2	—	—
Net Periodic Benefit Cost	$5	$4	$1	$2

	Pension Benefits		Other Retiree Benefits	
	Nine Months Ended September 30,			
	2013	2012	2013	2012
	Millions of Dollars			
Service Cost	$10	$8	$3	$2
Interest Cost	11	12	2	2
Expected Return on Plan Assets	(15)	(13)	(1)	—
Actuarial Loss Amortization	7	5	—	—
Net Periodic Benefit Cost	$13	$12	$4	$4

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NOTE 8. SHARE-BASED COMPENSATION PLANS

RESTRICTED STOCK UNITS

In May 2013, the UNS Energy Compensation Committee granted 8,870 restricted stock units to non-employee directors at a grant date fair value of $48.99 per share. We recognize compensation expense equal to the fair value on the grant date over the one-year vesting period. The grant date fair value was calculated by reducing the grant date share price by the present value of the dividends expected to be paid on the shares during the vesting period. Fully vested but undistributed non-employee director stock unit awards accrue dividend equivalent stock units based on the fair market value of common shares on the date the dividend is paid. We issue UNS Energy Common Stock (Common Stock) for the vested stock units in the January following the year the person is no longer a director.

In February 2013, the UNS Energy Compensation Committee granted 21,560 restricted stock units to certain management employees at a grant date fair value, based on the grant date share price, of $46.23 per share. The restricted stock units vest on the third anniversary of grant and are distributed in shares of Common Stock upon vesting. We recognize compensation expense equal to the fair value on the grant date over the vesting period. These 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 companies included in the Edison Electric Institute Index during the performance period of January 1, 2013 through December 31, 2015. We recognize compensation expense equal to the fair value on the grant date over the vesting period if the requisite service period is fulfilled, whether or not the threshold is achieved. The remaining half had a grant date fair value, based on the grant date share price, 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. We recognize compensation expense equal to the fair value on the grant date over the requisite service period only for the awards that ultimately vest. 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 $1 million of share-based compensation expense for the three months ended September 30, 2013 and September 30, 2012. For the nine months ended September 30, 2013, UNS Energy recorded share-based compensation expense of $3 million, $2 million of which related to TEP. For the nine months ended September 30, 2012, UNS Energy and TEP recorded share-based compensation expense of $2 million.

At September 30, 2013, the total unrecognized compensation cost related to non-vested share-based compensation was $4 million, which will be recorded as compensation expense over the remaining vesting periods through February 2016. At September 30, 2013, 1 million shares were awarded but not yet issued, including performance shares, under the share-based compensation plans.

NOTE 9. 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 numerator in calculating diluted EPS is Net Income adjusted for the interest on Convertible Senior Notes (net of tax) that would not be paid if the remaining notes, not yet converted, were converted to Common Stock.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	Thousands of Dollars			
Numerator:				
Net Income	$67,990	$50,664	$113,953	$83,414
Income from Assumed Conversion of Convertible Senior Notes [1]	—	—	—	1,100
Adjusted Net Income Available for Diluted Common Stock Outstanding	$67,990	$50,664	$113,953	$84,514
	Thousands of Shares			
Denominator:				
Weighted Average Shares of Common Stock Outstanding:				
Common Shares Issued	41,472	41,290	41,427	39,835
Fully Vested Deferred Stock Units	178	156	169	148
Total Weighted Average Common Stock Outstanding – Basic	41,650	41,446	41,596	39,983
Effect of Dilutive Securities:				
Convertible Senior Notes [1]	—	—	—	1,417
Options and Stock Issuable Under Share-Based Compensation Plans	378	417	345	319
Total Weighted Average Common Stock Outstanding – Diluted	42,028	41,863	41,941	41,719

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	Thousands of Shares			
Stock Options	—	—	—	67
Restricted Stock Units	—	—	8	—
Total Anti-Dilutive Shares Excluded from the Diluted EPS Computation	—	—	8	67

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NOTE 10. SUPPLEMENTAL CASH FLOW INFORMATION

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

	UNS Energy	
	Nine Months Ended September 30,	
	2013	2012
	Thousands of Dollars	
Net Income	$113,953	$83,414
Adjustments to Reconcile Net Income		
To Net Cash Flows from Operating Activities		
Depreciation Expense	111,175	105,319
Amortization Expense	21,600	26,845
Depreciation and Amortization Recorded to Fuel and Operations and Maintenance Expense	5,399	4,911
Amortization of Deferred Debt-Related Costs Included in Interest Expense	2,280	2,250
Provision for Retail Customer Bad Debts	1,703	2,017
Use of RECs for Compliance	12,999	4,017
Deferred Income Taxes	77,962	63,057
Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset	(11,039)	—
Pension and Retiree Expense	17,087	16,391
Pension and Retiree Funding	(27,602)	(23,649)
Share-Based Compensation Expense	2,810	1,952
Allowance for Equity Funds Used During Construction	(4,145)	(2,708)
Increase (Decrease) to Reflect PPFAC/PGA Recovery	(6,814)	29,730
PPFAC Reduction - 2013 TEP Rate Order	3,000	—
Liquidated Damages for Springerville Unit 3 Outage	—	1,921
Changes in Assets and Liabilities which Provided (Used)		
Cash Exclusive of Changes Shown Separately		
Accounts Receivable	(32,883)	(28,686)
Materials and Fuel Inventory	14,839	(33,038)
Accounts Payable	(18,497)	(5,220)
Income Taxes	(15,847)	(11,738)
Interest Accrued	(2,137)	(1,551)
Taxes Other Than Income Taxes	18,718	16,478
Other	20,473	16,426
Net Cash Flows – Operating Activities	$305,034	$268,138

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	TEP	
	Nine Months Ended September 30,	
	2013	2012
	Thousands of Dollars	
Net Income	$96,433	$65,018
Adjustments to Reconcile Net Income		
To Net Cash Flows from Operating Activities		
Depreciation Expense	87,729	82,656
Amortization Expense	24,393	29,621
Depreciation and Amortization Recorded to Fuel and Operations and Maintenance Expense	4,602	3,922
Amortization of Deferred Debt-Related Costs Included in Interest Expense	1,831	1,628
Provision for Retail Customer Bad Debts	1,315	1,348
Use of RECs for Compliance	11,766	3,324
Deferred Income Taxes	64,132	51,638
Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset	(10,751)	—
Pension and Retiree Expense	14,909	14,466
Pension and Retiree Funding	(26,118)	(20,989)
Share-Based Compensation Expense	2,239	1,540
Allowance for Equity Funds Used During Construction	(2,923)	(2,265)
Increase (Decrease) to Reflect PPFAC Recovery	(5,079)	25,150
PPFAC Reduction - 2013 TEP Rate Order	3,000	—
Liquidated Damages for Springerville Unit 3 Outage	—	1,921
Changes in Assets and Liabilities which Provided (Used)		
Cash Exclusive of Changes Shown Separately		
Accounts Receivable	(42,542)	(44,269)
Materials and Fuel Inventory	14,955	(32,448)
Accounts Payable	(8,678)	4,977
Income Taxes	(10,681)	(11,424)
Interest Accrued	1,008	2,729
Taxes Other Than Income Taxes	17,405	16,710
Other	15,234	11,898
Net Cash Flows – Operating Activities	$254,179	$207,151
Non-Cash Transactions		

In August 2013, TEP recorded an increase of $39 million to both Utility Plant Under Capital Leases and Capital Lease Obligations due to TEP's commitment to purchase leased interests in January 2015. See Note 5.

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 5.

In September 2012, TEP declared a $30 million dividend to UNS Energy which was paid in October 2012.

In the first nine months of 2012, UNS Energy converted $147 million of the previously outstanding $150 million Convertible Senior Notes into Common Stock, resulting in non-cash transactions.

In the first nine months of 2012, TEP's redemption of $193 million of tax-exempt bonds resulted in a non-cash transaction.

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NOTE 11. FAIR VALUE MEASUREMENTS AND DERIVATIVE INSTRUMENTS

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, directly or indirectly. Level 3 inputs are unobservable and supported by little or no market activity.

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 calculated 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 incorporated the impact of counterparty credit risk using market credit default swap data. TEP's Investment in Lease Debt matured in January 2013.

- 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 conducted 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:

		September 30, 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	24	36	23
Liabilities:					
Long-Term Debt					
UNS Energy	Level 2	1,506	1,522	1,498	1,583
TEP	Level 2	1,224	1,215	1,223	1,271

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	UNS Energy					
	Total	Level 1	Level 2	Level 3	Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets(5)	Net Amount
	September 30, 2013 Millions of Dollars					
Assets						
Cash Equivalents(1)	$31	$31	$—	$—	$—	$31
Restricted Cash(1)	2	2	—	—	—	2
Rabbi Trust Investments(2)	21	—	21	—	—	21
Energy Contracts - Regulatory Recovery(3)	2	—	1	1	(2)	—
Total Assets	56	33	22	1	(2)	54
Liabilities						
Energy Contracts - Regulatory Recovery(3)	(11)	—	(5)	(6)	2	(9)
Energy Contracts - Cash Flow Hedge(3)	(1)	—	—	(1)	—	(1)
Interest Rate Swaps(4)	(8)	—	(8)	—	—	(8)
Total Liabilities	(20)	—	(13)	(7)	2	(18)
Net Total Assets (Liabilities)	$36	$33	$9	$(6)	$—	$36

	UNS Energy					
	Total	Level 1	Level 2	Level 3	Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets(5)	Net Amount
	December 31, 2012 Millions of Dollars					
Assets						
Cash Equivalents(1)	$20	$20	$—	$—	$—	$20
Restricted Cash(1)	7	7	—	—	—	7
Rabbi Trust Investments(2)	19	—	19	—	—	19
Energy Contracts - Regulatory Recovery(3)	7	—	2	5	(5)	2
Total Assets	53	27	21	5	(5)	48
Liabilities						
Energy Contracts - Regulatory Recovery(3)	(15)	—	(7)	(8)	5	(10)
Energy Contracts - Cash Flow Hedge(3)	(2)	—	—	(2)	—	(2)
Interest Rate Swaps(4)	(10)	—	(10)	—	—	(10)
Total Liabilities	(27)	—	(17)	(10)	5	(22)
Net Total Assets (Liabilities)	$26	$27	$4	$(5)	$—	$26

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	TEP					
	Total	Level 1	Level 2	Level 3	Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5]	Net Amount
	September 30, 2013 Millions of Dollars					
Assets						
Cash Equivalents[1]	$15	$15	$—	$—	$—	$15
Restricted Cash[1]	2	2	—	—	—	2
Rabbi Trust Investments[2]	21	—	21	—	—	21
Energy Contracts - Regulatory Recovery[3]	1	—	1	—	(1)	—
Total Assets	39	17	22	—	(1)	38
Liabilities						
Energy Contracts - Regulatory Recovery[3]	(3)	—	(2)	(1)	1	(2)
Energy Contracts - Cash Flow Hedge[3]	(1)	—	—	(1)	—	(1)
Interest Rate Swaps[4]	(8)	—	(8)	—	—	(8)
Total Liabilities	(12)	—	(10)	(2)	1	(11)
Net Total Assets (Liabilities)	$27	$17	$12	$(2)	$—	$27

	TEP					
	Total	Level 1	Level 2	Level 3	Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5]	Net Amount
	December 31, 2012 Millions of Dollars					
Assets						
Cash Equivalents[1]	$1	$1	$—	$—	$—	$1
Restricted Cash[1]	7	7	—	—	—	7
Rabbi Trust Investments[2]	19	—	19	—	—	19
Energy Contracts - Regulatory Recovery[3]	3	—	1	2	(1)	2
Total Assets	30	8	20	2	(1)	29
Liabilities						
Energy Contracts - Regulatory Recovery[3]	(3)	—	(3)	—	1	(2)
Energy Contracts - Cash Flow Hedge[3]	(2)	—	—	(2)	—	(2)
Interest Rate Swaps[4]	(10)	—	(10)	—	—	(10)
Total Liabilities	(15)	—	(13)	(2)	1	(14)
Net Total Assets (Liabilities)	$15	$8	$7	$—	$—	$15

(1) Cash Equivalents and Restricted Cash 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 is included in Investments and Other Property – Other on the balance sheets.

(2) Rabbi Trust Investments include amounts related to deferred compensation and Supplement Executive Retirement Plan (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), power options (Level 2), gas 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 on the UNS Energy and TEP balance sheets. The valuation techniques are described below.

(4) Interest Rate Swaps are valued based on the 3-month or 6-month LIBOR 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.

(5) All energy contracts are subject to legally enforceable master netting arrangements to mitigate credit risk. We have presented the effect of offset by counterparty; however, we present derivatives on a gross basis on the balance sheets.

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DERIVATIVE INSTRUMENTS

Regulatory Recovery

We are exposed to energy price risk associated with our gas and purchased power requirements. 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 Note 2.

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 or use quoted prices in an inactive market, 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 gas options using a Black-Scholes-Merton option pricing model which includes inputs such as implied volatility, interest rates, and forward price curves. Beginning in the third quarter of 2013, the fair value of our power options is based on contractually specified option premiums instead of the Black-Scholes-Merton option pricing model because the needed inputs are no longer available. Based on the change, we transferred the power options out of Level 3 and in to Level 2 at the end of third quarter of 2013. The amount transferred was less than $0.5 million. We record transfers between levels in the fair value hierarchy at the end of the reporting period. There were no other transfers between levels in the periods presented.

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.

Cash Flow Hedges

We enter into interest rate swaps to mitigate the exposure to volatility in variable interest rates on debt. These swap agreements expire through January 2020. We also have a power purchase swap to hedge the cash flow risk associated with a long-term power supply agreement. This swap agreement expires in September 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 12. The loss expected to be reclassified to earnings within the next twelve months is estimated to be $4 million.

Financial Impact of Energy Contracts

We record 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 income statements or in the statements of other comprehensive income, as shown in following tables:

	UNS Energy		TEP	
	Three Months Ended September 30,			
	2013	2012	2013	2012
	Millions of Dollars			
Increase (Decrease) to Regulatory Assets/Liabilities	$1	$(12)	$1	$(6)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	UNS Energy		TEP	
	Nine Months Ended September 30,			
	2013	2012	2013	2012
	Millions of Dollars			
Increase (Decrease) to Regulatory Assets/Liabilities	$—	$(20)	$2	$(7)

Realized gains and losses on settled contracts are fully recoverable through the PPFAC or PGA. At September 30, 2013, UNS Energy and TEP have energy contracts that will settle through the third quarter of 2016.

Derivative Volumes

The volumes associated with our energy contracts were as follows:

	UNS Energy		TEP	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
Power Contracts GWh	1,819	2,228	856	820
Gas Contracts GBtu	29,022	17,851	8,504	7,958

Level 3 Fair Value Measurements

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

	Valuation Approach	Fair Value at September 30, 2013 Assets	Liabilities	Unobservable Inputs	Range of Unobservable Input
		Millions of Dollars			
Forward Contracts[1]	Market approach	$1	$(7)	Market price per MWh	$23.00 - $48.00

[1] TEP comprises $2 million of the forward contract liabilities.

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:

	Three Months Ended September 30, 2013	
	UNS Energy	TEP
	Millions of Dollars	
Balances at June 30, 2013	$(5)	$(1)
Realized/Unrealized Gains/(Losses) Recorded to:		
Net Regulatory Assets/Liabilities – Derivative Instruments	(3)	(1)
Settlements	2	—
Balances at September 30, 2013	$(6)	$(2)
Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period	$(2)	$—

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) - Unaudited

	Nine Months Ended September 30, 2013	
	UNS Energy	TEP
	Millions of Dollars	
Balances at December 31, 2012	$ (5)	$ —
Realized/Unrealized Gains/(Losses) Recorded to:		
Net Regulatory Assets/Liabilities – Derivative Instruments	(4)	(2)
Settlements	3	—
Balances at September 30, 2013	$ (6)	$ (2)
Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period	$ (5)	$ (1